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PROCEEDINGS OF THE FIRST ANNUAL MEETING OF THE
TEXAS APPLIED ECONOMICS CLUB

Some
Corporation and Taxation Problems
of the State
and a Statement of the Reasons for
an Applied Economics Club

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PREFACE

The object of this publication is, not to push out the bounds of human knowledge, but to spread abroad some of the knowledge already gained. Primarily, it seeks to call the attention of the citizens of Texas to the existence of the most important economic problems of that State and suggest what seem to be the best solutions. A circular letter was sent to a number of thoughtful men in different sections of the State, and in answering all agreed that the subjects of Taxation, Capitalization of Railways, and Corporations, are among the problems which most urgently demand attention. Accordingly, the thought of the best advanced students of economics in the State University was directed by their instructors toward these problems, and, in addition, certain public-spirited men of affairs were interested. The papers here presented are the result. These papers are of unequal merit. It is to be observed that most of them are the work of undergraduate students, and, as it has not seemed fair or expedient to rewrite them, a degree of naivete is apparent at points. It is believed, however, that all have the merit of clearly and concisely calling attention to important points bearing on matters of real moment. Especial attention should be called to the papers on Railway Capitalization. Here will be found in brief compass the best discussion of that subject that has appeared in this State.

The editor has used his scissors freely and in some cases mutilation may have resulted. Anyone who has ever attempted a similar task will appreciate the difficulty of giving correct and uniform style to a group of student essays. He, therefore, craves the leniency of the very critical. On the other hand, he confidently expects the approval of the broad-minded men who appreciate the value of scientific and independent thought on such topics. Needless to say he would not accept full responsibility for all the suggestions and propositions contained in the papers. Finally, he would call attention to the efficient and unselfish activities of Dr. E. T. Miller and Mr. C. B. Austin in assisting in the direction of the work of the students on these papers;

and to the scholarly and patriotic spirit with which Judge N. A. Stedman, Judge W. D. Williams, Hon. Rudolph Kleberg, and Mayor A. P. Wooldridge have contributed to the work.

Above all, Texas may well be proud of those loyal young sons who here dedicate the first fruits of their fertile brains to the purpose of making her a better State.

THE EDITOR.

I.

The Ends and The Means of An Applied Economics Club

PAPERS EXPLAINING THE PURPOSE AND SPIRIT OF THE INVESTIGATIONS
CONTAINED IN THIS PUBLICATION

THE NEED FOR SCIENTIFIC ECONOMIC INVESTIGATION IN TEXAS

HON. RUDOLPH KLEBERG.

Hon. Rudolph Kleberg, Vice President of the Club, being called upon at the first annual meeting of the club for an expression of opinion, said in part:

Mr. Chairman, Ladies and Gentlemen: I congratulate the members of the Texas Applied Economics Club upon the auspicious beginning they have made. Today the club has been permanently organized, and is now launched as a State institution, which is destined to become an important factor in the industrial development of Texas. The necessity of such an organization, for the systematic gathering and dissemination of reliable scientific data and information upon economic problems, can not be overestimated by any one who is conscious of the present portentous industrial and fiscal problems which are pressing for intelligent solution, and the inadequacy of understanding in the public mind with regard to correct economic principles. This is chiefly due to the fact that until recently the public has been mainly engaged in agricultural and pastoral pursuits, and the world-wide movement of social and industrial unrest has escaped their attention. Now, however, they are confronted by this great and rapid movement which challenges the best and clearest thought of every citizen, and especially of those public servants who are intrusted with the conduct of public affairs. New conditions have forced upon us new and intricate problems which call for intelligent, prompt, and courageous action. Thus we observe everywhere that men organize themselves into civic associations such as bankers', merchants', and manufacturers' associations, labor unions, etc., attending their annual conventions held in different parts of the State, discussing and deliberating upon economic questions in a practical way; all of which is wise and commendable. But what is wanted more than anything else at the present time is an association of patriotic, disinterested thinkers, who will make it

their object to study and investigate industrial and fiscal problems, in order to bring out the scientific facts and economic principles underlying them, for practical use and application. This task devolves chiefly upon the faculty and advanced students of the School of Economics of the University of Texas, assisted by such disinterested citizens as have the time and the ability to aid them. Disinterested, impartial, industrious, thorough-going scientific study and analysis, and wide publicity of its results among our people are required to make this work effective. The labor of the theorist and student of economics must accompany that of the man of affairs.

The questions of private and municipal corporations, State county, and city taxation, control of public and private corporations, public transportation, public utilities, public sanitation, and a number of other kindred questions, press us on all sides for adequate solution, and this work can not be effected in a haphazard way, but only by scientific methods. This is recognized the world over, and the foremost nations have pressed their universities into service and are achieving the most satisfactory results. Texas must not lag behind in this great work, but must press forward to prepare favorable conditions for the capital and immigration that are now pouring into her borders to convert her rich opportunities into wealth and prosperity. Upon you young gentlemen and ladies and the great faculty of this University chiefly depends this laudable undertaking.

But above all, you must guard against the pit-falls of the extremist, and refuse to commit yourselves to the teachings either of the unrestricted individualist or of the radical socialist. Although among their votaries may be found some bright minds, such votaries do not possess the temper of the true investigator, whose beacon light must be truth.

It is not the purpose of this club to antagonize capital or legitimate investment, but rather to encourage both in order to make greater opportunity for thrift and enterprise. But the members of this club recognize the fact that the time for individual enterprise on a small scale has passed forever, and that the era of corporate enterprise has irrevocably taken its place, and that intelligent thorough-going control is necessary to protect alike, private investment and effort on the one side, and

individual and social rights on the other; that unless this control is applied, neither industrial progress nor social justice can be attained; that we have come to the parting of the ways where we can neither follow the advocates of rank individualism, nor those who would revolutionize economic conditions and bring about industrial chaos. The way we must travel rather leads to social reform by means of the evolution of present economic conditions based upon the application of rational scientific methods. This is the broad and hopeful vista that opens up to our view; this is the great field of opportunity in which our efforts and investigations must be applied, to the end that we may furnish the business man, the legislator, and the citizen generally, reliable information and data which may conduce to more intelligent action in the future growth and development of our great State.

MEANS AND ENDS OF A TEXAS APPLIED ECONOMICS CLUB.

LEWIS H. HANEY.

An applied economics club is an association for studying and discussing practical economic problems. Its immediate purpose, to borrow from the constitution of this club, will be "first to understand the principles of economics; second, to understand the economic or industrial situation; and, third, to learn from experience." Ultimately it will seek to promote the economic welfare of the community in which it exists and to that end will seek to apply sound economic analysis in the light of history.

It will be observed that this idea embraces both a study of general principles, and a knowledge of concrete conditions. It is eminently fitting, then, that the membership of such a club should consist of both students of economics and men engaged in direct contact with concrete problems. Accordingly, the Texas Applied Economics Club provides for two classes of members: active members, including chiefly those who are studying the general principles of economics; and associate members, including chiefly those who as practical and public-spirited citizens are applying economics to the best of their knowledge. Needless to say, an associate member may and should be a very *active* member! Thus these will be the following interests to be considered in any discussion of ends and means: Students—both in and out of academic life,—and men of affairs; universities, and the State.

On this occasion, the academic interests may be disposed of very briefly. Students will have their interest in the broader aspects of State problems aroused and a sounder sense of civic duty must issue. (Indeed, the distinction between the interests of State and the university is often rather artificial. Both are social institutions acting and reacting upon one another, and the student of today is the trained state builder of the future.) The student will become trained in research, in independent investigation in that most difficult of all laboratories, the

library. Finally, one reflects that the student of today is the local or State leader of affairs tomorrow and that the future influence of student members is being stored up as a mighty potentiality. As to the universities, I confine my remarks to the leading State institution of learning. "Put the university at the service of the State." is the watchword of the Club. It seeks to establish a bond between the thought of the university and the leaders of action in the State. Why should the State be maintaining an expensive library and faculty in economics; why should advanced students be solving problems in economic theory,—and the State not profit directly? The result we seek is better generalization—better theory, if you please—in State affairs; and more practicality and concreteness in university study. Both may gain thereby.

Turning now to the associate members and the State, we note that the club has great potentialities for good. The constitution states that "in order to further its ends, the club will endeavor to secure the co-operation of the officials and representatives of the State government." Its associate membership is stated to consist of persons who will increase the effectiveness of the club through ability, interest, or position in the affairs of the State. Thus the emphasis is properly laid upon the work of the club in its purpose of bettering conditions in the State. But it must not be forgotten that the associate member need not come away without benefit. He, too, may feel the quickening touch of research. He may have his attention called to the broader social aspects of the particular problems which confront him each day. He may be shaken or gently rolled out of ruts, and be put in the way of doing greater good to his State. It is certainly one aim of the club to put the school of economics of the university at the service of its associate members, and in behalf of the active membership I hereby tender their activities.

Highest of all ends, however, stands the service of the commonwealth, the State. Merely to have helped to keep this end in view would be sufficient justification for any club. But we believe that besides this we can do much good. The club may seek to ascertain and define what are the true economic troubles of the State. It may trace their causes, and then seek a remedy,—not forgetting the experience of sister States. In doing

this it may put a broad scientific spirit into the solution of such problems. Too often our legislation is narrow, selfish, partisan; too often our administration is weak, untrained, short-sighted. These things are the antipathy of the club.

But how is so great a purpose to be followed out? The means? In the first place there must be careful investigation of facts. Without full knowledge of conditions in the State and the experience of other States, progress must be halting and stumbling. To this end the club will seek to build up a special library of the statistics and laws of this and other States to supplement the university and State capitol libraries. In this way it will be able to put the fullest information at the disposal of its members.

To be quite definite, we can point to the work of the club during this its first year. The following papers have been prepared: The Democratization of Corporation Control, Publicity and Corporation Regulation, Foreign Corporations, The Public Utilities Commission Movement, The Taxation of Corporations in Texas, Organized Labor and the Texas Anti-Trust Law, Are Texas Railways Overcapitalized?, Physical Valuation in Texas, The Personal Property Tax in Texas, The Taxation Needs of Texas. Some of these are excellent and well worth consulting by any one; others possess less spirit. All have done good. Parts at least of all will be published as a university bulletin. At each meeting current events of economic significance are discussed and reports on progress are made by those preparing papers. These reports are thrown open to the club and freely discussed with the result that many valuable ideas emerge from the common mind. Moreover the close contact between the students and the professors is beneficial to both. Sometimes the associate members of the locality drop in and participate.

In the second place, the club will seek to mold public opinion through the agency of public meetings, published proceedings, and the press. The results of each year's investigation will be published—possibly as a bulletin of the University—and if, as the plan is, the work of the club is made to bear directly upon important Texas problems, surely some light will be shed. It is planned to watch the editorials and contributions of the leading Texas papers to be alert to question unsound logic or supple-

ment a worthy appeal. And the club will do all in its power to get a hearing for any non-partisan speaker of ability who may be desirous of discussing matters of importance to Texas.

Again, some good may possibly be done by a direct influence upon legislation and administration. With our headquarters at the capital city and the leading men of the State among our members, the possibilities are not small. Many an honest legislator would be glad to have some source of information at hand to which he could turn for the sake of perfecting his bill or arming himself for debate. If the bill should concern economic matters—and most bills do—could the Club not be that source? It should be a duty of this organization to take such an interest in the economic affairs of the State that it would be in a position to contribute something to the construction of a bill dealing with such affairs. Then, too, there is the work of administrative or executive departments. Frequently the railway, tax, and labor commissioners run up against problems or desire knowledge, statistical or otherwise, which their time and appropriations do not allow them successfully to cope with. Moreover, they sometimes feel the importance of securing the judgment of those who by training are proficient in economics on matters where general principles are involved. I can assure them that the school of economics stands ready to do what it can in the way of statistical investigation or advice on economic theory, and the services of the club are at their disposal.

It has been a most encouraging achievement of this first year's work to have enrolled among our members a leading railway commissioner, our tax commissioner, our labor commissioner, the mayor of our capital city, and several of the most eminent lawyers of the State. It speaks well for the spirit of these gentlemen and it holds out great promise for the future influence of the club.

Finally, the club furnishes a new device: the non-political machine! A machine which shall be non-partisan. Each year its associate membership will be swelled by outgoing graduates, who in an increasing body will occupy positions of leadership in their local communities. In time, State leaders will arise from among them. Will they then forget the ways of their youth or their association in the club? Such is not the wont of Texans!

This cog in the machine will more and more supplement the existing one which our distinguished associate members more or less unwittingly form. Our judges and lawyers, our legislators and commissioners, our newspaper men and bankers, even the professor,—all form part of a potential machine. Surely we may all work in a broad spirit of constructive citizenship to further the common weal of our great commonwealth.

Does all this sound over-ambitious? Then observe that it is said in all modesty and expresses a hope and a desire rather than a foolish prejudgment. Let us try. Nor do we believe that all this could come in a day or a year. But five years is a very short period of time. Besides, there stands Wisconsin as a living example. Her laws and administration clearly illustrate the application of economics, and "the Wisconsin idea" has become a beneficent phrase. The Texas Applied Economics Club says, "Let us go and do likewise!"

II.

The Corporation Problem

HOW THE STATE CAN MAKE ITS CORPORATIONS BETTER CITIZENS

1. PRIVATE BUSINESS CORPORATIONS.

THE DEMOCRATIZATION OF THE CORPORATION.

LOWEL L. WILKES.

Although it is at present subject to serious abuses, all will admit that the corporation is the most effective form of business organization yet devised. The abuses will be found to spring from selfishness fostered by secrecy and to appear in various forms of manipulation by majorities and "inside interests." It is the object of the following paper to seek an answer to the question, how may the corporation be made a good citizen, and to show that by giving it a more democratic control this end may be reached. By "democratizing" the corporation, is meant the perfection of the organization to the end that it may be raised in the eyes of the public. This would be attained largely by giving more protection to the citizens of the little republics called corporations—the stockholders.

The States have all passed laws with the idea of the democratization of the corporation. Of course, the number and nature of the laws have been different, due largely to the different development of corporations in the States. The law of Texas relating to democratized control of corporations is by no means as extensive or as inclusive as that of many other States. As a means of explaining this condition we should note that either one or both of two things is true: Either corporation development has not reached the stage in which such legislation in all its complexity is needed, or else the management has not been corrupt enough to demand it. Taking everything into consideration, the latter seems to be the best reason. But, as we shall see later, certain laws do not appear on the statutes in Texas which it seems should appear, even though fraud and manipulation are not now present to any great extent.

The laws of Texas, which concern democratized control, are along three general lines: (1) relating to stockholder's meet-

ings, including majorities, (2) liabilities of directors and stockholders, and (3) publicity to stockholders, including records. Of these three, the last is the most interesting and inclusive.

As regards stockholder's meetings, the law simply provides that these meetings are to be held at a certain time and place as provided in the by-laws. Nothing whatever is said as to notices to stockholders containing the purpose of the meeting, or as to those who are qualified to vote. Likewise we find nothing referring to the character of voting allowed* and limitations thereon or the inspection of elections where fraud is carried on or provision for calling meetings other than those specified in the by-laws. They do state definitely, however, the majority required for carrying amendments or measures of most importance to the corporation. A two-thirds majority of *all* stock is required to increase the capital, while a three-fourths majority is required for the dissolution of the corporation. In every such case more than a bare majority of those voting is required and generally the laws specify that it shall be from two-thirds to four-fifths of the subscribed stock. This is a good way of protecting the stockholders, because it works as a limitation upon the majority in that they can not so easily pass measures especially beneficial to themselves.

The Texas laws also place certain restrictions on the directors in the form of liabilities where they do not work entirely for the interest of all the stockholders alike. Where directors knowingly declare and pay a dividend when the corporation is insolvent, or one which would render it insolvent, they shall be jointly and severally liable for all debts thus incurred, provided the debt does not exceed the amount of dividends paid.** The secretary of a corporation is liable when a plaintiff in any execution against the corporation demands a list of the stockholders' names, place of residence, and amount of stock held by each, and he fails to furnish it. The directors have the general management of the corporation's affairs. The law provides, how-

*Cumulative voting is allowed in the case of railroads.

**The proviso deprives the measure of much of its deterrent value. The damage done to the corporation may be much more than the amount of dividends paid. Mere civil liability to the amount of the fraudulent dividends hardly makes such action risky enough. (Ed.)

ever, that where they fail to use the securities as prescribed in the by-laws they become liable; but it does not say how much nor to what extent.

We have already seen that no provision is made for causing information to be given to the stockholders as to the purpose of meetings or as to those of the general list of stockholders who are qualified to vote. The law does, however, provide for certain definite information which those having the affairs in hand are compelled to give to the stockholders. Most important is the provision which says that the directors shall cause a record to be kept of all stock subscribed and transferred, and of all business transactions. Also it is provided that their books and records shall, at all reasonable times, be open to the inspection of any and every stockholder. Whenever one-third of the stockholders shall demand reports in writings of the situation of the corporation's business, or declare expedient dividends, those having such matter in charge must comply with such demands. Nothing, however, is said about notice of new issues of stock, or of auditors to inspect the books.

When one is asked the question: "What is the premier corporation State in the United States?" the immediate answer is, New Jersey. This does not mean, necessarily, that the corporations in that State have the best regulation from the standpoint of the public. It refers primarily to the fact that the laws in this State are most favorable to the corporations, and this is true to such an extent that most of the largest corporations have secured their charters in New Jersey. The fact that New Jersey is one of the oldest corporation States and has also reached such a high state of corporation development makes it very interesting to study its laws in connection with this subject. For, as we would naturally expect, the subject of the protection of minority holders has occupied a very important place, and the statutes provide for more protection against fraud on the part of the majority than most other States.

The law of New Jersey specifies very clearly everything connected with stockholders' meetings. In the first place, when meetings are not held on the day specified in the by-laws, the stockholders must be furnished with adequate notice as to the time, place, and purpose of the meetings, and in any case as to

the purpose. The regulation of voting is especially significant. The stock books, and not certificates of stock, determine who shall vote; and the secretary must prepare an annual list of stockholders before each meeting, which list each stockholder shall have a right to inspect for himself.

The usual forms of voting are provided for in the statute,—regular voting (one vote for each share of stock held), cumulative voting (for each share, one vote for each director to be elected), and voting by proxy. Likewise, provision is made for voting pools and trusts, but nothing is said as to their regulation and nature. Two interesting limitations as to voting are very much in point here: (1) no proxy shall be voted on more than three years from its date, and (2) no share of stock which has been transferred on the books of the corporation within twenty days next preceding any election is to be voted on at such election. Especially noteworthy is the latter provision.

But from the standpoint of this paper, the conduct of the elections is most important. Although the State does not in express language require inspectors of elections, the election must be by ballot and it is usual to provide in the by-laws that at all elections of directors, two inspectors or judges shall be appointed by the chairman of the meeting. They are ordinarily sworn to the faithful performance of their duty, and when the polls are closed they present a written report as to the count of votes and outcome of the election. They have the transfer books as evidence of right to vote. One very helpful thing from the point of view of the stockholders, is that they have a right to make complaints to the chancellor of the election as to any fraud they may suspect in connection with any such elections. The latter may investigate the election to see whether or not it was held according to the statutory provisions. Pending such investigation the chancellor may restrain the persons claiming the election from exercising any of the duties and functions of such offices.* The stockholders also have a right to make complaints of this nature to the supreme court.

*These provisions appear weak on the administrative side; for there is no adequate safeguard against a biased choice of officials, and instead of a mandatory "shall" only a permissive "may" is used in providing for their functions. (Ed.)

Two other facts in connection with the elections deserve especial attention. First, no person is allowed to serve as director who is not a stockholder, and no one who is candidate for a directorship can serve as an inspector of elections. The second and most unique, but at the same time the most important of all the provisions from the stockholder's standpoint, is that where a regular meeting is not provided for in the by-laws, three or more stockholders may call a meeting by publishing the time, place, and purpose.

Little is said of a definite nature as to the liability of directors. The management and business affairs are entrusted to the officers and directors and when the latter fail to discharge their duties according to the by-laws and constitution, the stockholders have a right to make complaint with the possibility of securing an injunction against them. When stockholders themselves make complaint as to the wisdom of the moves and administration by the directors, and no fraud is proven, the only remedy is for such stockholders to sell their stock and withdraw from the corporation.

We have already seen that the stockholders are to have adequate notice as to the time, place, and purpose of all meetings of stockholders. Besides this, much information and publicity of far more importance is also provided for. They have a right to examine the transfer books besides having access to the annual list of the stockholders. The stockholders have the right at reasonable times to examine the books and records of the company, and in case they are refused such privilege they can take action for damages. Where there is fair reason to believe that information is desired and intended to be made use of improperly, the request can be refused and the court will not grant a mandamus.

In case of increase of stock, the statutes provide that notice must be given to the stockholders of such increase, and they have first right to subscribe to this new stock in proportion to their holdings.

Although these provisions may give the stockholder access to the information he needs, it seems strange that no provision is made for an annual written report to be sent out to the stockholders.

Such is the nature of the New Jersey law. All that has been attempted has been to give the law as it stands without any criticism. The above citations by no means constitute all the provisions bearing on the subject. But they include all the more important ones necessary for this study; those omitted being more detailed in their nature and for the most part are restrictions and additions to those mentioned.

It would be unnecessary to take up in detail all the States included in this study, because in the main the law of one State is a duplication of that of the other States. Especially is this true since we have considered New Jersey, the State with the largest number of provisions. Therefore in the consideration of the other States, it is only necessary to take up such provisions as are peculiar to each one.

Wisconsin stands next to New Jersey from the standpoint of provisions bearing on democratized control. In the main the provisions are exactly alike. But in the citations which will be given here, it will be shown that the Wisconsin law is, in some cases, far more effective than the former. As regards liability of directors for certain acts, the Wisconsin statute states definitely the amount of the same, thus making for less abuse of such provisions. When directors fail to report or allow inspection of books (under Section 1757) by stockholders or creditors, they shall forfeit not less than \$25 or more than \$100 for each and every offense in favor of the aggrieved stockholder or creditor. But in case the directors have reason to believe the proper use is not to be made of this information they may refuse such request.

There are also some interesting provisions in connection with stockholders' meeting. Where special meetings are called, or any other than regular business is to be transacted, the stockholders must have adequate written notice. In case the elections are held and the majority are enjoined from them, such elections are valid. And likewise when elections are held, in connection with which the ownership of stock is doubtful, such elections are to be held over. When it is impossible to get a fair and unselfish inspector of election, the court can appoint one. All of these provisions make for less fraud in elections and certainly give more protection to minority stockholders.

Very little importance occurs in connection with publicity and information. The only important provision is that one which allows stockholders to have skilled auditors or examiners as their representatives, who are allowed to audit the books each year. This largely prevents the "doctoring" of the books by the officers and directors.

The proposed law for the State of New York as given in Jenks' "*Trust Problem*" is perhaps the most inclusive collection of provisions bearing on this given subject. It is not, however, of as much importance as one of the other ones, because it never became a law. But it is of importance because it shows a serious and enlightened study looking toward democratized control.

In this proposed act there is made the fullest provision for information to stockholders. In the first place, the stockholders are given full information as to all their rights in connection with their stock certificates. Besides this, they are entitled to a balance sheet, prepared and certified by an auditor, as well as the copy of the salaries and obligations of the officers. Other information of a detailed nature is also given—a copy of the proceedings of directors' meetings, a record of all transfers of stock, and a statement of all stock issues whose consideration is other than cash. With such information at hand the stockholder may know the exact condition of the corporation.

The only significant point in connection with the stockholders' meetings is that they can limit to a very large extent some of the actions of the officers and directors. All increases in the salaries of the officers and directors, as well as elections of officers and directors at times outside of regular stockholders' meetings, are subject to ratification by the stockholders at their regular meeting. Another important point is that the majorities required for carrying any question before the meetings are relatively high, in almost every case being from two-thirds to three-fourths and four-fifths of the stock of the corporation.

Little is said with respect to liabilities of stockholders and directors. The latter can not, however, make loans of money to any stockholder which withdraw in effect any part of money paid by him on his stock. Besides this, they are required to purchase stocks of any stockholder who dissents in the voting

on amendments to the certificate of incorporation. The former is the more important one, because under it the directors *representing the majority* can not make loans to that majority.

The Massachusetts statute presents a very interesting provision in the requirement which says that every five years the officers must publish in Boston and in the county newspaper a list of all dividends and balances with names of persons to whose credit they stand.

The Pennsylvania statute contains an interesting provision relating to cumulative voting, allowing it in all corporations. Its wording is similar to that in New Jersey. But the significant thing is the fact that it has worked with so much success. The report of the Commissioner of Corporations calls particular attention to this fact, giving specific instances where it has attained the desired result of limiting majority control in elections.

Turning now to Germany, we see a new tendency in the form of a body intermediary between the stockholders and the board of directors. This body is known as the Council of Supervision. Its members are elected at the general meeting of the stockholders, and exercise general supervision over the business for the stockholders. Their duties are three-fold: (1) to investigate transactions undertaken in the founding of the company, (2) to oversee the management of business in all its dealings and keep themselves informed as to the progress of the company's affairs, (3) to assume a joint liability with the directors. Likewise, the stockholders may call for a general meeting through this body. All of these things tend to keep the stockholders informed as to the condition of the corporation, and also to restrain the majority from putting through any selfish schemes.

Nothing new appears in the provisions concerning stockholders' and directors' liabilities. The directors are liable for misuse of funds and for failing to use business prudence in the general conduct of the corporation's affairs. Then, there are specific cases in which they are liable, e. g., where they fail to call a meeting of stockholders when a part of the capital (one-half of the share capital) is lost.

Practically all the information the stockholder receives is through the Council of Supervision. He may, however, demand

written notice of meetings, the subjects to be discussed, and resolutions adopted at any meeting. The report of the promoter is given in detail to him in the articles of incorporation.

Whenever shareholders representing one-twentieth of the capital demand a meeting and submit in writing two weeks beforehand the subjects to be discussed, and the directors fail to call it, the courts may force them to do so and allow any matters to be discussed which the stockholders desire to bring before such meeting. In the case of general meetings, two weeks notice must be given, so as to allow shareholders to deposit their shares, which gives them the right to vote. A list of shareholders or their representatives must be prepared and be left open to inspection before the first ballot is taken. The majorities required vary with the importance of the subject before the meeting; resolutions require a simple majority, while amendments to by-laws or changing the object of the company require three-fourths majority. Fraud in elections is strictly guarded against and offenses of this nature are punishable by heavy fines.

The English law tries to solve the problem by laying particular stress on publicity.*

We might consider further the laws of other States and countries, but they would add little to the ones we have considered. Besides, these are sufficient to show the position Texas occupies in comparison with other governments. It remains now to take up the second point to be considered in this paper, and to suggest some amendments to the Texas law. It is obvious that the changes which might be suggested can not be brought about at any one time, for beneficial movements of this nature must generally come by degrees.

The evils which exist in the present corporate form of business have been suggested, as well as what seem to be the remedies for these evils. It will only be necessary, then, to enumerate the changes, which at present seem to be needed to bring about that democratized control which will mean so much to the public and to the corporation itself. It might be well to add that not all of the evils above mentioned are so prevalent in Texas as in some eastern States.

*See the following paper on "Publicity."

Reform in Texas seems to be most necessary along two lines: (1) publicity and information, and (2) conduct of meetings, elections, voting, etc. As a result of the comparison with the other States, the following seem to be the provisions which will to a great extent remedy the evils now existing in this connection:

(1) Stockholders should receive the following reports: (a) a detailed report from the promoter, (b) adequate notice of the time, place, and purpose of all stockholder's meetings, (c) a record of all stockholder's meetings, (d) a record of all director's meetings, (f) a list of all stockholders, names, residence, etc., (g) a record of the company's receipts and disbursements, and an adequate balance sheet, (h) a notice of all new issues of stock, (i) a report from a disinterested auditor who inspects the books.

(2) They should be given by statute increased rights personally to inspect the books with definitely stated means of enforcing such rights speedily and with adequate penalties.

(3) They should be allowed to appoint an auditor to inspect the books.

(4) It might also be well to give them the right to elect a Council of Supervision to act as an intermediary between themselves and the directors. Such provisions would give the stockholder much fuller knowledge of the affairs of the corporation and would leave little room for "graft" on the part of the majority or of the directors.

There is, furthermore, a great need for reform as to the conduct of elections. In the first place, provision should be made for inspectors of elections, as well as a supervisor, to whom complaints might be made. Cases of fraud and misuse of voting power should incur criminal liability as well as mere civil liability. All kinds of voting should also be allowed, cumulative as well as regular voting; and voting by proxy might well be subjected to some limitations. Candidates for office should be required to own a certain amount of the issued capital according to the importance of the office and such candidates should not hold office in rival companies. But what seems most necessary is the limit to the amount of votes any one person could cast. This would prevent the majority from electing

all the officers. Cumulative voting would also remedy this evil, and it has worked with marked success in Pennsylvania. The majorities for passing resolutions or amendments should vary with their importance. Here the German plan would best be followed. Resolutions in meetings should require a simple majority, while such matters as the increase of capital stock or the amendment of by-laws should require a large one, three-fourth to four-fifths.

The solution for the misuse of the funds and "grafting" by directors seems to be simpler. At present the liability of directors is purely civil. If a definite and wisely adjusted criminal liability were added by statute, there seems to be no reason why many of the evils of majority control could not be prevented. The liability of stockholders as it now exists seems to be adequate for most business. They should be liable to the amount of their stock. This liability is the same in all the States and countries that have been considered. But where a stockholder owns above a certain amount of stock, it might be well to increase his liability in order to correlate it with the amount of control he possesses.*

It is not to be inferred that these changes will remedy all the corporation evils, but that they will reduce such evils to a large extent is certain. At any rate, the individual stockholder would acquire much more power, and by this means the corporation might be made a more desirable citizen of the State. For extended democratization within, or government control from without, seem to be the only alternatives for solving the existing corporation problem.

*This interesting suggestion goes to the heart of the corporation problem, though it is put somewhat baldly by the writer of the paper. To insure a responsibility which will be coördinate with power is the gist of the whole question. Some means, then, of insuring that those who dominate the corporation's actions shall bear a major part of the responsibility, both legal and financial, for those actions, is of capital importance. (Ed.)

EFFECTIVE PUBLICITY FOR CORPORATIONS.*

F. L. VAUGHN.

Perhaps the biggest problem facing the nation today is the regulation and control of large corporations. Within the past two decades the nation and the States have passed many laws against trusts, the corruption of legislation, discriminations, and other corporation abuses. Yet under this multiplicity of laws the same evils continue to exist. The trouble is that our legislation, both State and national, has been too much judicial and not enough administrative. We permit the continued existence of the conditions that encourage the evils which we attempt to remedy. We strike at the effect, rather than the cause. What is needed is something that will destroy the lurking place for these various evils. For this reason publicity of corporation accounts is proposed.

Before stating the publicity which should be required of corporations in order to remedy certain corporation abuses, attention should be directed first to the laws of various States of the Union, and of foreign countries, which provide for reports from corporations. After this is done, the Texas law regarding publicity of corporation accounts will be given, and then specific additions to this law will be proposed.

Reports from corporations are required for two reasons; namely, for the purpose of taxation, and for a better regulation of the organization from the standpoint of the public. Under this latter head comes publicity for the benefit of the stockholders. The former is common to the statutes of all States. However, only a few of the States require much publicity for the latter reason. Massachusetts, Wisconsin, and New York are among the relatively few States which require detailed reports

*Publicity has become a hackneyed term and as generally used has little significance. The aim of Mr. Vaughn's paper is to make the term significant by giving it a definite meaning. It seeks to state in a detailed way just what steps must be taken to make real and effective publicity and what good may result. (Ed.)

from the corporations doing business within their borders. Massachusetts takes the lead in this requirement.

1. *The Corporation Publicity Laws of Certain States Other Than Texas.*

First, the Massachusetts requirements for the domestic corporation will be considered. Such a corporation must keep at its principal office the agreement of association, the articles of organization, a true record of all meetings of the stockholders, and stock and transfer books, all of which are open to the inspection of stockholders. Further, each corporation must prepare an annual certificate attested by its president and at least a majority of its directors. If the capital stock is over \$100,000 the report is to be accompanied by a sworn statement of an auditor employed by a committee of three stockholders, stating that such report represents the true condition as shown by the books. The report must contain the following information: first, the name of the corporation; second, the location of its principal business office; third, the date of its last preceding annual meeting; fourth, the total amount of its authorized capital stock, the amount issued, outstanding, and paid thereon, the classes into which it is divided, and the par value and number of its shares; fifth, the names, addresses, and the terms of office of all its directors and officers; sixth, a statement of its assets and liabilities. The "assets" must show the values of the following: real estate, machinery, merchandise (manufactures, merchandise, material, and stock in process), cash and debts receivable, patent rights, trade marks, good will, and profit and loss. "Liabilities" must disclose the amounts of these items: capital stock, accounts payable, funded indebtedness, floating indebtedness, surplus, and profit and loss.

This report is submitted to and examined by the Commissioner of Corporations. If he finds that it conforms to the requirements of the law, he indorses his approval thereon. Upon the payment of a fee of \$5.00, the report may be filed in the office of the Secretary of the Commonwealth, who receives and

preserves it in book form convenient for reference, and open to the public inspection.

The report required of foreign corporations is very similar to that of domestic corporations. After paying the necessary fees, the foreign corporation files with the Commissioner of Corporations a copy of its charter and of its by-laws. Also, the foreign corporation must make a report to the State like that required of the domestic corporation.

Moreover, very full and detailed information is given to the tax commissioner for the purpose of taxation. This, however, is open to inspection only by the State officials.

In Wisconsin, both domestic and foreign corporations make reports to the Secretary of State. The following information is given: the name and address of the corporation; the names of its officers; its authorized capital stock; the amount of capital stock actually paid in money, property, and services; and a statement as to whether it was engaged in active business during the preceding year. In addition to the above, the foreign corporation must state the proportion of the capital stock represented in the State by its property located and business transacted therein during the preceding year. Furthermore, the Wisconsin statutes provide that the Attorney-General, whenever required by the Governor, shall examine the condition of any domestic corporation, and report the details of such examination to the Governor, who is to lay the same before the Legislature. Also, the Legislature has the power to inspect the affairs of any corporation of the State. For this purpose any committee of the Legislature may examine the books, vaults, papers, and documents of the corporation.

The statutes of Minnesota require publicity of the prospectus of each domestic corporation. Before the corporation can receive its charter from the State, it must state in a legal newspaper published at the capital of the State, or in the county where such corporation is organized, its articles of incorporation. The following facts must be disclosed: the name of the corporation, the general nature of its business, and its principal office; the time of its formation and the period of its continuance; the amount of its capital stock and how paid; the highest amount of indebtedness or liability to which it shall at any time be subject;

the names and places of residence of its members; the names of its first board of directors, and in what officers or persons its government and the management of its affairs are vested, and when the same are elected; and the number and amount of shares in its capital stock.

The domestic corporations of Kansas must make a similar report to the Secretary of State. In addition, they must make a complete and detailed statement of the assets and liabilities of the company.

The national government has done much towards publicity of corporation accounts. The Interstate Commerce Law requires returns from railroad companies as to earnings and expenses, and as "to issues of bonds and stock and the status and value of property." The returns required of national banks are very minute and exacting. These institutions have flourished under this searchlight of publicity. They have inspired public confidence. As a result, there is an ever growing tendency at Washington to require greater publicity of corporations. Many bills have been introduced to this effect. The Littlefield Bill of 1906, which provided for greater publicity of corporations engaged in inter-state commerce, passed the House but not the Senate.

The need and effect of publicity are clearly given in the report of the Industrial Commission of 1900. The main features of the report were as follows: To prevent the organizers of corporations or industrial combinations from deceiving investors and the public, whether through suppression of material facts or by making misleading statements, the commission recommends: (a) That the promoters and organizers of corporations or industrial combinations which look to the public to purchase or deal in their stocks or securities should be required to furnish full details regarding the organization, the property or services for which stocks or other securities are to be issued, the amount and kind of same, and all other material information necessary for safe and intelligent investment; (b) that any prospectus or announcement of any kind soliciting subscription which fails to make full disclosure as aforesaid, or which is false should be deemed fraudulent, and the promoters with their associates held legally responsible; (c) that the nature of the business of a corporation or an industrial combination, all powers granted to the

officers and directors thereof, and all limitations upon them or upon the rights of the members, should be required to be expressed in the certificate of incorporation, which instrument should be open to inspection by any investor. The larger corporations—the so-called trusts—should be required to publish annually a properly audited report, showing in reasonable detail their assets and liabilities with profit or loss, such report and audit to be under oath and to be subject to government inspection. The purpose of such publicity is to encourage competition when profits become excessive, thus protecting consumers against too high prices, and to guard the interests of employes by a knowledge of the financial condition of the business in which they are employed.

A very recent and pronounced tendency towards publicity of corporation accounts is shown in the report of the Railroad Securities Commission of 1911. The Commission recommended “the adoption of provisions regarding publicity which will show the actual facts regarding stock and bond issues in the several States, and the consideration received therefor.” Further, according to this report, every railway engaged in inter-state business which issues bonds or stocks should be required by statute to furnish the Interstate Commerce Commission at the time of the issue with a full statement of the details of the issue, the amount of the proceeds, and the purpose for which the proceeds are to be used, followed in due time by an accounting for such proceeds. The mode of procedure in securing this publicity is to rely on general statutory provisions under which the directors may issue such securities, being held responsible for their proper use. The report to the commission should contain “a full statement, including the names of the parties concerned, of all financial transactions that have taken place during the period covered by the report, whether in cash, in securities, or in other valuable considerations, and whether embraced in income account or outside of it.” Moreover, this statement should include the disposition of the surplus. Further, the commission should have the power to inspect the books of the company, and to examine into the actual cost as well as the value of the property acquired or services rendered. Attention should be called to the important facts which must be given in this report. It will be no-

ticed that this commission advances one step further by having the report include the disposition of the surplus. The recommendations show the great need for more knowledge of the corporations' affairs in order to control them better. Although this report concerns only public-service corporations, it can, nevertheless, be applied to certain conditions in Texas.

Considerable publicity is required by the Federal Corporation Tax Law of 1909. According to this law corporations must make reports to the national government each year, disclosing the following information: amount of paid-up stock outstanding; amount of bonded or other indebtedness; all the ordinary and necessary expenses of maintenance and operation of the business and properties of the organization; amount of losses and of depreciation during the previous year; interest on bonds or other obligations; and, finally, the net income. After the assessment is made these returns are filed in the office of the Commissioner of Internal Revenues as public records, and are open to public inspection as such.

2. *Foreign Laws.*

Next, attention should be turned to the laws of other countries requiring publicity of corporation accounts. England and Germany have the best laws in this respect. In Germany the articles of incorporation of the proposed company must be published in the sworn statement. This statement must be inserted in public papers, and in the *Reichsanzeiger* (the official newspaper of each province). It must state these facts: first, the firm name and location of the company; second, the object of the undertaking; third, the amount of share capital and of the separate shares; fourth, the method of election and the constitution of the board of directors; fifth, the manner in which the general meeting of shareholders is called; sixth, the manner in which notices emanating from the company are to be published. Further, the articles of incorporation must contain a statement, in case shares are issued for other than cash contributions, of the nature of such contributions, the persons making them, and the number of shares issued as compensation therefor. The legal steps taken to secure such non-cash contributions must likewise

be stated, together with the market cost and cost of improvement of the property for the two years preceding the deal; and in case of the acquisition of a business by the company, information must be given as to the profits of the business for the same length of time.

All special advantages granted to individual stockholders, and the names of persons thus favored, must be stated. Also, the total amount expended in founding the company must appear in the articles of incorporation. Each separate expense must be given, showing the persons for whom it was incurred and the amount and kind of compensation paid to them: for example, the commission for securing subscriptions to shares, and the promoter's remuneration.

In addition to containing some of the foregoing requirements, the English "Companies Act" requires the prospectus to state the amount payable for rent, the amount or estimated amount of preliminary expenses, the amount of commission for securing subscription to shares, the dates and parties to every material contract made three years before the date of publication of the prospectus, and a reasonable time and place at which such contracts may be inspected.

Ordinarily the shareholders in Germany exercise supervision over the business of the company through a Council of Supervision consisting usually of three members, and elected by the general meeting of stockholders. Notice of any change in the personnel of this council must be made in the newspapers, and sent to the business registry. The first Council of Supervision examines into all transactions undertaken in the founding of the company. A report is made showing the results of these examinations. This council must keep itself informed as to the progress of the company's affairs. It may at any time demand an account regarding the company's condition from the board of directors, and may examine into the amount of cash, securities, and goods on hand. It must examine into and report to the general meeting on the annual accounts, balance sheets, and propositions regarding the distribution of dividends.

Besides this Council of Supervision, there is another means for the stockholders to exercise control over the business. The general meeting is empowered by a simple majority vote to appoint

revisers to examine the balance sheet of the company, or any of the transactions connected with the founding or the ordinary conduct of its business. Even if a majority in general meeting is not obtainable for a motion to appoint revisers, shareholders, representing one-tenth of the capital of the company, may petition the court of the district to appoint revisers to examine into any transaction connected with the formation of the company or with the ordinary conduct of its business.

There must be posted at every general meeting a list of the shareholders, giving their names, addresses, and the number of shares represented by each. This must be open for inspection before the first ballot is taken.

Before and at a meeting of a company in England, reports are made. The information thus given is similar to that furnished to the stockholders in Germany, the difference being that in England the report is made by the directors, while in Germany by the Council of Supervision or by the revisers. Also, in England, auditors who are neither directors nor officers of the company have the full right to investigate the affairs of the company in detail, and to certify to the accuracy of the annual report and balance sheet as representing accurately the general condition of the company.

Aside from the report made to the court of registry, the stock company of Germany is not required to make statements to the government. However, the above mentioned report contains considerable information. After a company publishes its articles of incorporation in a newspaper, it must apply to the court of the district in which it is located for entrance in the business registry. This application must be accompanied by its articles of incorporation, and all other papers and documents regarding its founding. After this information is filed, the company then becomes qualified to do business.

In England the corporation must furnish the government with information similar to that filed in the court of registry by the company of Germany. However, in the case of the former the report must be made annually, and not just before commencing business. In England, moreover, a register must be kept by the Registrar of Joint Stock Companies, disclosing the following: first, any mortgage or charge to secure debentures; second,

a mortgage or charge on uncalled capital: third, a mortgage or charge created or evidenced by an instrument which, if executed by an individual, would be a bill of sale; and fourth, a floating charge on the whole undertaking or property of the company. This register is open to public inspection, and a copy of it is kept at the company's office.

3. Texas Corporation Publicity Laws.

Next, one should consider the extent to which the Texas statutes provide for publicity of corporation accounts. First, every fiduciary corporation must publish in some newspaper of general circulation in the county where such company is organized, on the first day of February of each year, a sworn statement of its assets and liabilities on the previous 31st day of December. A copy of this must be filed with the Commissioner of Insurance, Statistics and History, who may examine the affairs of the company at any time.

The domestic corporation of Texas must keep a record of all stock subscribed and transferred, and of all business transactions, and its books and records are open at all reasonable times to the inspection of every stockholder. It must also, when required by one-third of the stockholders thereof, present reports in writing of the situation and of the amount of business of the corporation. Also, the secretary must furnish, on demand of the plaintiff, in any execution against the corporation, the names and places of residence of the stockholders, and the amount of stock held by each, as shown by the books of the corporation.

For the purpose of ascertaining the amount of any annual franchise tax, every domestic and foreign corporation in the State must report annually between the first and tenth days of March, and also upon the demand of the Secretary of State, the total amount of the capital stock issued and outstanding, and the surplus and undivided profits respectively, if any, of such corporations as of the previous first day of March. Further, the secretary may ascertain such facts from other sources.

Judging from the foregoing, it is evident that, with the exception of reports for taxation, very little detailed and definite

publicity of private corporations is required in this State. But the contrary is true in the case of public-service corporations. Every street railway company and every corporation furnishing gas, electricity, water, or sewerage to towns of over 2500 population, must file annually a report with the Secretary of State, showing these facts: first, its authorized capital stock, the amount and kind—common or preferred—of such stock that has actually been issued, and how much is due on unpaid stock; second, its bonded indebtedness, the number of bonds sold, and the rate of interest, the time of maturity, and the selling price of such bonds; third, any other fixed lien or mortgage upon its property; fourth, its floating indebtedness, including all bills payable of whatever nature; fifth, the value of its visible tangible property, giving separate values of lands, machinery, buildings, tracks, and equipment, and in gross all bills receivable and cash on hand; sixth, its annual cost of operation, showing separately, the amount paid for salaries, for labor, for fixed charges, for fuel, for extension, repairs, and maintenance, and for miscellaneous expenses; seventh, its annual gross earnings, including revenues from every source; eighth, the price charged for its services.

This report is made under oath by any officer of the company having knowledge of the required information. A true copy of this report is filed annually with the mayor of the city and the clerk of the county court of the county where the corporation has its principal place of business. After the county clerk delivers the report to the commissioners court, it is recorded in a properly indexed book, and open to the inspection of the public at all times.

4. *Suggestions for Further Legislation.*

After making this brief survey of various corporation laws relative to publicity for corporations, it will be well to suggest a few provisions that could be wisely added to the corporation laws of Texas.

One of the worst abuses arising in connection with corporations is a misrepresentation or concealment of material facts regarding the organization of an enterprise. Today, when new

combinations are being continually formed, there is much unscrupulous promotion. Frequently a promoter of a large corporation receives a tremendous compensation for his services. Only a few months ago, it was discovered, after an investigation by our national government, that the promoter of the United States Steel Corporation received over \$70,000,000 for his services. But how is the investor to ascertain such facts? There is absolutely no way; he is in the dark. For this reason a corporation should state in a newspaper published in the county where the company is organized, its articles of incorporation, containing these facts: the name, the general nature, and the principal office of the business; the highest amount of the indebtedness to which it shall be subject at any time; the names and addresses of its officers and directors; the expense of formation of the company; the amount of authorized, issued, and outstanding stock; and what the stock represents—whether personal services, the actual value of the plants, brands, good will, or earning capacity.

Further, more knowledge and protection should be given to the stockholder. Each domestic corporation should keep at its principal office its articles of incorporation, a true record of all meetings of stockholders, and the stock and transfer books. All this material should be open to the inspection of the stockholder. But even this is often times insufficient information properly to protect the stockholder. The officers and directors of the company may draw exorbitant salaries, may make fraudulent contracts, may misuse inside information or may juggle the accounts of the corporation. In any case, the average stockholder is almost powerless to make an investigation. He certainly ought to have a way to ascertain whether the affairs of the company in which his money is invested, are honestly and ably managed. Therefore, it is recommended that at least one-tenth of the stockholders should have the right to petition the district court to appoint a committee to examine the books of the company or any transaction connected with its founding or with the conduct of its business. Of course, this petition should not be granted unless these stockholders can furnish adequate evidence to create a presumption that the affairs of the corporation are being **mismanaged**.

Also, by concealment, corporations are enabled to profit at the expense of the public in two ways: first, competition may be prevented through ignorance of the opportunity for profit on the part of other capital; and second, the consumer may suffer under exorbitant rates. The two are, of course, closely inter-related. Again, then, there is a demand for the white light of publicity. The report made to the State by each industrial incorporation of the State should be published in some prominent paper so that the public may better judge the condition and the policy of the corporation. In order to restore the public confidence in the industrial enterprise, there must be an exercise of intelligence by the people. This being true, more information regarding corporations is a necessity.

As was mentioned at first, one great benefit that will result from detailed reports of corporations is a better administration of the corporation laws. The statutes of Texas fairly bristle with provisions against corporation evils. This State forbids unfair discriminations, trusts, monopolies, the corruption of legislation by gifts from corporations, and other corporation abuses. But who knows to what extent these laws are obeyed? A corporation may violate each one of them, and be unpunished. Therefore, the State must receive a full report from every industrial corporation doing business in the State, which should closely resemble that required by Massachusetts as outlined above. Also, the State must have the power to inspect the books of the corporation at all times.

Moreover, what is good in corporations should be preserved. In order to do this, the State, in regulating corporations, should have the fullest information concerning corporate earnings and policies.

Finally, it must be borne in mind that the business of some corporations is inter-State, while that of others is intra-State, and that the State can not exercise as much control over the former as in the case of the latter. The State and nation may both require publicity of foreign corporations. To the extent that their requirements may conflict, the national government must be given precedence over the State. Yet the two may co-operate in this respect as they do in regulating the railways. But these difficulties can be settled as they arise. What

is needed now is a remedy for certain corporation evils—a remedy that has been adopted by England, Germany, and every other European country, as the best solution of the problem. Can not the State and nation do likewise, and make our corporations better citizens?

SOME OBSERVATIONS ON "FOREIGN CORPORATIONS" AND THEIR REGULATION BY THE STATES.

ROY E. PATTERSON.

1. *General Statement of the Law of Foreign Corporations.*

A corporation has no existence beyond the limits of the State by which it was created. But by the principle of comity, which is part of the common law and obligatory upon the courts, a corporation may enter other States for the purpose of transacting business. It does so, however, subject to the limitations in its charter and the general laws of its State. With the consent of the State, express or implied, the foreign corporation may engage in business, make contracts, and maintain suits, provided its doing so is not contrary to any constitutional or statutory prohibition nor to the public policy of the State. The principle of comity does not require the courts to recognize a foreign corporation, nor enforce its contracts when to do so would be contrary to the laws or public policy of the State. Abstractly considered, it is within the power of a State, by means of a constitutional provision or an act of the Legislature, to exclude foreign corporations altogether, or prescribe any conditions in reference to them that may seem fit so long as that State violates no provision of its own or of the Federal Constitution.

Subject to the above mentioned restrictions, a foreign corporation may, by comity, acquire and hold real and personal property, take a lease or mortgage, and may take and hold property as trustee, executor, administrator, etc.; sue in the courts, or be sued; and, if it expressly or impliedly submits to the jurisdiction of the courts, personal judgment may be recovered against it.

The courts of a State have no visitatorial power over a foreign corporation, and can not regulate or interfere with its internal affairs and management. But they have jurisdiction to enforce individual rights of stockholders or members.

According to a decision of the Supreme Court in 1868 (*Paul vs. Virginia*, 8 Wallace, 165), a State has absolute power to exclude

a foreign corporation. Nor can its motive in doing so be questioned, as long as no constitutional provision is violated. According to another decision (*Doyle vs. Continental Insurance Co.*, 94 U. S., 535, 1877), a State may exclude a foreign corporation entirely, or restrict its business to a particular locality, and exact such security for the performance of its contracts with its citizens as in its judgment will best promote the public interest. The whole matter rests in the State's discretion. And in accordance with this principle, it is well established that a State may require a foreign corporation as a condition of the right to do business within its borders, to pay a certain license tax or fee, even though no such tax or fee, or only a less one, may be exacted from domestic corporations engaged in similar business.*

2. *Requirements for Admission to a State.*

As to the requirements before admission of a foreign corporation, those of Texas are about as numerous and severe as are to be found in any of the States. The fee or license tax required has been found to be higher in only one State of those investigated by the writer, namely, Alabama. There it is twenty-five per cent of the first \$100, five per cent of the next \$900, and one-tenth of one per cent on all of the authorized capitalization exceeding \$1000. This is very much higher than the cost of organization of a *domestic* corporation in Alabama, such fee being only one dollar per \$1000 of the authorized capital stock. In Massachusetts, a State noted for wise corporation regulation, the fee is uniform, being \$25.00 for any corporation whatsoever; and in New Jersey it is only \$10.00.

In the statement required to be filed with the Secretary of State before receiving a permit, setting forth the amount of capital stock, place of business, names of directors, etc., Massachusetts requires in addition to those things enumerated in the Texas statute, (1) that the names and addresses of the president, secretary, and treasurer be given, (2) the date of its annual meeting for the election of officers, (3) and if any part of the

*See Clark & Marshall, *Corporations*, No. 844 (b).

payment of capital stock has been made otherwise than in money, that the details of such payment be given so far as practicable. The last point may be very important. It will aid in determining whether the company is over-capitalized.

Massachusetts requires that every foreign corporation, before doing any business, shall appoint in writing the "commissioner of corporations and his successor to be its true and lawful attorney, upon whom all lawful processes in any action or proceeding against it may be served."

The laws of New Jersey permit corporations "carrying on any kind of business of the same or a similar nature" to merge or consolidate into a single corporation. And the laws of New York, New Jersey, Delaware and several other States have legalized the holding company. But the Texas Legislature, on the contrary, has been disposed to deal rather harshly with anything that smacks of combination. Texas stands alone (as far as the writer's investigation has extended) in requiring a principal officer, or two directors, on behalf of the corporation, to make affidavit that it is not a combination in restraint of trade, nor a party to any trust agreement, before granting a permit to transact business.

Texas is one among a few States that require foreign corporations before doing business to have a certain percentage of the capital stock paid up in cash.

3. *Franchise Taxes.*

As to the amount of franchise taxes levied, those of Texas are comparatively high. In North Carolina, for instance, only ten cents per \$1000 of the authorized capital stock is levied, and in no case shall the tax be greater than \$100. In Arkansas a tax of \$10 is levied on companies whose capital stock is \$25,000 or under; on those from \$25,000 to \$100,000, \$25 tax; from \$100,000 to \$500,000, \$50 tax; from \$500,000 to \$1,000,000, \$100 tax; all those whose capital stock exceeds \$1,000,000 must pay \$200 franchise tax. In Massachusetts, a franchise, or "excise" tax of one-fiftieth of one per cent of the par value of the authorized capital stock as stated in the corporation's annual report of con-

dition is levied, the amount of such tax in no one year to exceed \$2000. The franchise tax on foreign corporations in Texas is one dollar on each \$1000 of the capital stock up to \$100,000; \$2 on each \$20,000 in excess of \$100,000 up to and including \$10,000,000; and \$2 on each \$50,000 in excess of \$10,000,000. This means that our tax on corporations with a capitalization of \$100,000 or less is five times as great as that of Massachusetts. And while Massachusetts with her steady rate would charge the corporation with \$10,000,000 the limit—\$2000, we only levy a franchise tax of \$1360 on corporations of \$10,000,000 capitalization. The Texas tax is only fifty cents per \$1000 up to \$100,000 on domestic corporations, or only one-half that charged foreign companies; but on all over \$100,000, twenty-five cents per \$1000 is levied, so that a domestic company of \$10,000,000 capitalization would pay a franchise tax of \$2750 or a little more than twice what a foreign corporation of equal capitalization would pay.

One requirement made of corporations, usually domestic and foreign alike, partly as an aid to the proper assessment of the franchise tax, is an annual report of condition. This report, in Texas, must be made between the first and tenth of March to the Secretary of State setting forth: (1) the authorized capital stock of the corporation; (2) the amount of stock issued and outstanding; (3) the amount of surplus and undivided profits.

4. *Some Difficulties of State Regulation.*

“A corporation created under the laws of one State may acquire and hold real property in another State,” according to Sullivan*, if (1) it has the power to acquire and hold land in the State of its domicile, and (2) the holding and acquiring of land by foreign corporations is not contrary to the statutory law or public policy of the other State. In Missouri real estate may be held by a foreign corporation for only six years. In Massachusetts they may hold such real estate as may be necessary for conducting their business. In New Jersey any foreign corporation whatsoever, *other than municipal corporations*, may pur-

*See Sullivan, *American Corporations*, 466.

chase, convey, lease, hold, and use for the purposes of such corporation such real estate as may be devised or conveyed to it. In this State, the foreign corporation, like the *domestic corporation*, may hold real estate to the extent necessary for the purposes of its business, or take real property as security or payment for debts, but all lands acquired must be alienated within fifteen years from date of acquisition.

For the reason that the laws of some States are more favorable toward corporations than those of others, residents of one State sometimes organize a corporation under the laws of another State for the purpose of doing business in their own State. "Such incorporation is regarded as valid, unless it is an evasion and fraud upon the laws of the State of the incorporators' residence."^{*}

The point of the last paragraph is one that shows partially the inadequacy of the State system of regulating corporations, foreign, especially, in the best interests of society. The anti-trust legislation of the different States has been, for the most part, futile. An unbiased observer of Texas' experience with the oil trust would not deny that such has been the case with us. Furthermore the principle of comity has practically given organizers of corporations the choice of all the corporation laws of the various States. And though a State may make requirements to be complied with by corporations before they enter, still the State can not thoroughly investigate every corporation being admitted. (Since a corporation is an artificial being without soul to be damned, it would naturally have but few conscientious scruples even in making affidavit that it was not an organization in restraint of trade.) If a corporation is found to be obnoxious, and it is ousted, the ouster is merely from *exercise of franchises* in the State. We have already observed that, theoretically, a State has absolute power in preventing a foreign corporation from doing business within its borders. "But a State can not exclude a foreign corporation engaged in any way in the service of the government or inter-State commerce, and upon this principle practically no corporation can be actually excluded

^{*}See Sullivan, *American Corporations*, 459.

from any State, since different States are not different countries.¹²⁸

As already implied, it is a fact that business may be done in foreign territory through "drummers" as a part of interstate commerce without any possibility of State interference. Thus, promoters having free choice in the matter of the charter State, the subjects considered in making a choice are the enumeration and limitations of corporate powers and stockholders' liability, those things being the chief points of essential difference in State laws regarding incorporation. Hence a result of State incorporation as it is now practiced, is the promotion of piratical corporations formed outside of the very State or States in which they are intended to act, for the purpose of exercising powers or combinations of powers which the laws of the State or States in which they are intended to act forbid. A vast majority of the business done is done by foreign corporations. Any large corporation does a very small proportion of its total business in the State chartering it, so that what it finally amounts to, is that matters affecting many are directed by a few. To quote the *Report of Commissioner of Corporations* for 1904: "The present situation of corporation law may be summed up roughly by saying that its diversity is such that in operation it amounts to anarchy." And again, "The net result of this State system is thoroughly vicious."

5. *Removal of Cases to Federal Courts.*

Some States, among them Alabama and Kentucky, have statutes which prohibit foreign corporations from removing cases to the Federal courts. Such a provision was originally made by Texas and Iowa a part of the agreement to which the foreign corporation must assent before securing its permit to do business. But the United States Supreme Court in testing the Iowa statute in the case of *Barron vs. Burnside* (121 U. S., 186), said: "As the Iowa statute makes the right to a permit dependent upon the surrender by the foreign corporation of a privilege secured to it by

Hendrick, *The Power to Regulate Corporations and Commerce* (N. Y., 1906), §§ 47-50.

the Constitution and laws of the United States, the statute requiring the permit must be held to be void." Based upon this authority, the Supreme Court of Texas in its first chance to test the Texas statute, an act of April, 1887, declared it unconstitutional (*Texas Land & Mort. Co. vs. Worsham*, 76 Texas, 558). The Alabama statute is not a part of the agreement that a foreign corporation must assent to before securing a permit authorizing it to do business; but knowing of the existence of the statute, it certainly does assent to it impliedly at least. But in testing the Kentucky statute which applies to insurance companies, the United States Supreme Court, in the case of *Security Mutual Life Insurance Co. vs. Prewitt* (202 U. S., 246, 1905), declared it to be constitutional. The statute reads in part as follows: "If any company shall without the consent of the other party to any suit or proceeding brought by or against it in any court of this State remove said suit or proceeding to any Federal court, or shall institute any suit or proceeding against any citizen of this State in any Federal court, it shall be the duty of the commissioner to forthwith revoke all authority to such company and its agents to do business in this State." The conclusion of the court's opinion stated: "The effect of the statute is simply to place foreign insurance companies upon a par with the domestic ones doing business in Kentucky, no stipulation or agreement being required as a condition for coming into the State and obtaining permit to do business therein, the mere enactment of a statute which in substance says if you choose to exercise your right to remove a case into a Federal court, your right to do further business within the State shall cease and your permit shall be withdrawn, is not open to any constitutional objection."

Judge Jacob Trieber of the United States Circuit Court held the Arkansas "out-law act" unconstitutional.* That act provides that a foreign corporation must pay a tax upon its entire capitalization in order to do business in the State of Arkansas, and that in case it should remove suit into a Federal court, the Secretary of State should thereupon revoke its charter. Judge Trieber held that while a State has the right to exclude a foreign corporation with or without good reason, still the law was unconstitutional because it impaired the obligation of a contract. He

*See *Railway Age*, Oct. 18, 1907.

said that former acts of the Legislature under which foreign corporations had entered the State and invested large sums of money were contracts that the liabilities of interstate and foreign corporations should be no greater than those of domestic corporations; and that to prohibit foreign corporations from removing an action from a State to a Federal court while domestic ones had that right made the liabilities of foreign corporations greater than those of domestic corporations. He also held that for foreign corporations to be taxed differently from domestic corporations was an unconstitutional discrimination.

Clark and Marshall, in their three volume work on *Corporations*, published before the decision in 1905 in the case of *Security Mut. Life Ins. Co. vs. Prewitt*, writing on the authority of a State to prohibit removal of causes, and basing their statement on the decision in the case of *Barron vs. Burnside*, said that such a law is unconstitutional. But in a fourth volume supplemental to the original work, published in 1908, the former statement is retracted and just the opposite is put in place of it. Cook on the subject phrases it like this: The State can not prevent the removal of a suit to a Federal court, but it may prevent the foreign corporation from doing further intra-State business upon such removal.

In the light of the above facts, it seems safe to conclude that the State has the constitutional right to withdraw the permit of a foreign corporation if it chooses to remove cases to the Federal courts. However, the State has no power to prevent such action and a statute requiring a foreign corporation to surrender its right to that effect is unconstitutional.

The differing attitudes of the Supreme Court at different times on what is, in effect, the same question after all show that a great many questions arising in corporate regulation may be far from satisfactorily settled, and gives evidence that confusion exists. It also illustrates a struggle that is never-ceasing between the State and Federal authorities on some questions.

In regard to taxation, another case came up in 1907 in the United States Supreme Court similar to that concerning the Arkansas "out-law" act,* in which it was held that when a State has

*See *Am., etc., Co. vs. Colorado*, 204 U. S., 103.

authorized a foreign corporation to do business in the State after paying a certain fee, it can not by a subsequent statute require it to pay an additional fee which is not exacted also from domestic corporations. Some States have passed retaliatory statutes in regard to taxation. In *Phila. Fire Ass'n. vs. N. Y.* (119 U. S., 110, 1886), it was held that a State may impose on foreign companies a tax equal to the tax levied by the State creating the foreign corporation.

6. *Congress' Power in the Premises.*

The power of Congress which is available to meet the above indicated difficulties of State regulation is based on the commerce clause of the Constitution, which gives that body (Art. 1, Sec. 8) power "To regulate commerce with foreign nations, and among the several States and with the Indian tribes." Under this power, it is pretty well established that congress may (1) create corporations as a means of regulating inter-State commerce; (2) give such corporations power to engage in inter-State and foreign commerce; (3) prohibit any other corporation or individuals from engaging in the same; (4) "provide regulations for carrying on inter-State commerce generally and in such local affairs as are now left to the States in the 'silence of Congress' under the principle established in *Cooley vs. Port Wardens* (12 How., 299), and in the carrying out of such powers it may use any or all means 'which are appropriate, which are plainly adapted to that end, which are not prohibited, but consistent with the letter and spirit of the Constitution'."

The two most plausible remedies among several that have been suggested which might alleviate present conditions are Federal Incorporation and a Federal Franchise or License System for inter-State Commerce. A very thorough discussion of these two propositions may be found in the *Report of the Commissioner of Corporations*, Dec., 1904.

2. PUBLIC SERVICE CORPORATIONS.

THE PUBLIC SERVICE COMMISSION MOVEMENT

WALTER DEALEY.

Beginning in 1907, with the adoption by the States of New York and Wisconsin of comprehensive measures for the control of corporations which furnish public utilities, and continuing with ever-increasing strength until at present it is one of the greatest problems of the hour, the question of the regulation by commission of such public-service corporations presents itself to us for serious and immediate consideration. The regulation of one form of public utility, the railway, and the problem of how best to control the railway corporation for the best interests of all concerned, has been before the public mind for many years, and at the present time, in most of the States, more or less complete laws provide for the control of the railways. But only lately, comparatively speaking, has the question of the regulation of utilities more local in character come into prominence.

The regulation of these utilities, however, does not really present a new question, but merely the extension of an old one. The basis for the laws providing for commission control of railways, and in like manner for the control of other public-utility corporations, is that such corporations are of a quasi-public character. They are, in the first place, vitally essential to society. Moreover they are creatures of the State, endowed by that State with valuable rights and privileges, and dependent on the public for their existence; and, being endowed with such monopolistic privileges, they are in duty bound to make a return to the public granting them such privileges, such return being the provision of adequate service at rates that are just and reasonable. Such is the basis for the laws. That laws are necessary for the regulation of such business, now need hardly be stated. In almost every town of over 5000 inhabitants, we

find corporations of this kind that are not giving the public its just return—corporations that are either not furnishing adequate service, or not furnishing such service at rates that are just and reasonable. Even granting, for the sake of argument, that the corporations of a community are providing in the main adequate service at just rates, there would still be the need of a commission to act as an intermediary between the individual and the corporations, to settle any little disputes that might arise, to insure against social loss because of duplication of plants, to protect the investor in corporation securities against watered stock, to act as a safeguard against *possible* evils, at least—in short, to answer a thousand and one little calls that come up daily in every urban community.

By 1911, in addition to New York and Wisconsin, Massachusetts, Maryland, and New Jersey had provided for the establishments of such commissions. At the present time, Washington, Georgia, Connecticut, Kansas, Michigan, Nevada, New Hampshire, Ohio, and also many municipalities have public-service commissions, and the State of California has recently adopted a law providing for the establishment of a commission in that State.* Practically every Legislature in the entire country has considered bills modeled on the laws of some one of the States just named. The successful operation of the commissions and the accompanying improvement in the service afforded by the corporations has given a distinct impetus to the movement.

What is the meaning of this widespread movement? It seems that the people are coming more and more to realize that these corporations are, because of their character, fit *subjects* for control and regulation, and for varied reasons *deserving* of such regulations; that the best and only real means of controlling is not by legislative action or by public officials who know little or nothing of the businesses they seek to regulate, but by commissions of specially trained and thoroughly competent engineers and ac-

*The following is a more complete and analytical list: 1911—Cal., Kas., Nev., N. H., O., Oreg., Wash.; 1910—Md., N. J.; 1909—Vt.; 1907—N. Y., Wis.; 1885—Mass. Virginia (1902) and Oklahoma (1907) have corporation commissions which exercise some power over public utilities. Commissions in Georgia and Nebraska have power over some public utilities, and Michigan and Connecticut may also be mentioned. (Ed.).

countants, men who can and do investigate the actual conditions and men capable of sound and scientific judgment upon public-utility conditions and values. Says an official of a public-service corporation, "Operators do not fear regulation based on intelligent inquiry and unbiased consideration. It is but natural that they should be apprehensive of regulation until they know something of the personnel, the qualifications, and unprejudiced attitude of the men called upon to decide the important questions involving the rights of the public, the operator and the investor. Once satisfied of the capacity and freedom from prejudice of the regulators they are willing, even anxious, to have them make rules for their guidance." Every honest corporation is willing that its affairs should be investigated when necessary, and that its policy should be regulated for the best interest of the public from which it derived its rights and privileges. To such a corporation a commission is without doubt beneficial.

A public-service commission composed of the right sort of men, a commission that is capable of scientific investigation of the many problems that come before it can do much to provide adequate service and yet do justice both to the corporation and the public. Perhaps a consideration of the laws of the five States that were first to adopt this form of a regulation, New York, Wisconsin, Massachusetts, Maryland, and New Jersey, and a review of the workings of these commissions in practical life, will serve to explain the reason for this widespread movement which we note.

Wisconsin regulates by State commission common carriers and all companies for the conveyance of telegraph or telephone messages or "for the production, transmission, delivery, or furnishing of heat, light, water or power either directly or indirectly to or for the public." The remaining four States provide for the regulation of practically the same utilities, except that in Maryland, all services connected with common carriers and also refrigerating companies come under the law.

As to *organization*: The Wisconsin law places public utilities under the control of the Railroad Commission, composed of three members, appointed by the governor with the Senate's consent, for a term of six years at a salary of \$5,000. The gov-

ernor may remove for certain causes, such as inefficiency, neglect of duty, misconduct in office, etc.; provided, an opportunity for a hearing is given to the member removed. In New York, two commissions are needed, one for the city of New York and the counties adjacent, and the other for the remainder of the State. Each has five members, at a salary of \$15,000; and counsel at \$10,000, secretary at \$6,000, as well as all necessary experts, assistants, and employees are provided for. Such high salaries attract the best men of the country to the commission. In other respects, the commission is practically the same as to organization as the Wisconsin commission. In Maryland, Massachusetts, and New Jersey, practically the same conditions obtain, except that in the second state three commissions are maintained,—the railroad commission, the gas and electric light commission, and the highway commission.

As to the *general powers* of the commissions in the various States, they are allowed to exercise supervision and registration of all public utilities provided for by law, and to do all things necessary and convenient to the exercise of their power of supervision, subject to the conditions imposed by law. They must keep informed as to the general condition and service of all public utilities under their control, and they have full power to examine and ascertain same. They can compel the attendance and testimony of witnesses, the production of books and papers, and may enter upon any property for the purpose of investigation.

As to *procedure* in investigation, the commissions have the power to investigate any public utility, and must investigate on petition of certain societies, bodies politic, municipal organizations, or groups of persons. If, after investigation, it is found that the service is inadequate, or the rate unfair, or the practice unreasonable, the commission shall fix a rate, service, or practice to be followed in the future. In some States, a comprehensive classification of service must be made by the commission, and each public utility must conform to that classification. In some States, moreover, specific power of enforcement of the commission's orders is not given, and the commission is left to rely on public opinion or legislation for the enforcement of its decrees. The New Jersey commission may hear complaints and issue

orders concerning service, but has no rate-making power. In all States, the accounts, papers, and information in the possession of public-service corporations must be open for the inspection by the commission. Schedules of tariff and service must be furnished the commission, and such can not be changed without due notice to the commission.

In all five States, the commissions are given the power to enforce an uniform system of accounting by all persons, corporations, or municipalities under their jurisdictions. In some States, the provision is mandatory. In Wisconsin, the commission is given the power to require depreciation funds to be kept by any public utility. The Wisconsin railroad commission law provides all the prohibitions and requirements as to transportation by common carriers and extends those applicable to other public utilities. Discriminations are prohibited, and compliance with all orders of the commission required. Every public utility, person, or corporation having subways, poles or conduits, shall permit the use of the same by any other public utility for a reasonable compensation when public convenience and necessity require such use, and when no irreparable injury to the owner nor substantial detriment to the service will result. Compensation may be fixed by the commission upon request.

Each State makes careful provision for the control of stock and bond issues of public-service corporations, and, in the main, they are all similar in prohibiting such issues except when permitted by the commissions, after a hearing to determine the necessity or wisdom of the issues.

The New York law provides that the construction of no utility shall be begun until, after a hearing, the commission decides that said construction is necessary or convenient for the public service. The Maryland law is similar to this, and all are modelled on the Massachusetts law which contains provisions requiring the approval of the commissions as to public necessity before a corporation may exercise a franchise. The Massachusetts law provides also for revocable permits which are similar to the indeterminate permits of Wisconsin. Such an indeterminate permit is a permit running without limit as to time and having attached thereto the following two conditions: (1) If the corporation has complied with the law and taken out an indeterminate

permit, no license, permit, or franchise shall be granted to any similar concern within the same municipality unless the commission finds that public convenience and necessity require such second public utility. (2) The corporation, by acquiring such a permit, consents to the purchase of its permit by the municipality in which it operates at a price to be fixed by the commission, with the right of appeal to the courts on said price. The legislature of 1911 forced all public-utility corporations to take out such a permit.

Municipally owned public utilities are likewise under the control and supervision of the commissions of the various States. They are treated exactly as if they were privately owned and operated.

The Wisconsin law provides for a valuation by the commission of the property of all public utilities. In determining such value, the commission may use any information in the possession of the State Board of Assessment. A revaluation may be made at any time on the initiative of the commission. Maryland adopted a like provision and required a separated statement of the property in each municipality. The other States give no such grants of power but in certain cases there is implied power in particular cases to value property as a basis for rate making.

Every order of the commission of New York goes into effect at the time stated in the order. A rehearing may be had, but in the meantime, until rescinded, the order must be carried out. Violation is punishable by fine, and each day's violation constitutes a separate offense. In Wisconsin, the orders go into effect twenty days after they are served, unless the commission otherwise determines. Violations of the law or orders of the commission subjects the public utility and its officers and agents to a fine. The Maryland law is similar to the New York law. In Massachusetts, only the gas and electric commission has such powers, the other two commissions being dependent upon public sentiment or legislative action. Enforcement in New Jersey, due to confusion in the law, is very feeble.

In New York and Maryland, the commissions may prescribe the form of reports required of utilities. The reports required by the Wisconsin law are detailed in the law. Gas and electric

companies must make detailed reports to the commission in Massachusetts. Telegraph and telephone companies must report to the Highway Commission as prescribed, and common carriers to the Railroad Commission.

In New York, preference on the calendars of the courts over all other cases of a civil nature except election cases is given to the cases of the commission. The Wisconsin law provides the form of procedure. In suits to set aside the decision of a commission, the burden of proof falls on the party desiring to set such decision aside. If any evidence is introduced before a court which was not introduced in the hearing before the commission, the court shall submit the evidence to the commission, and stay proceedings for fifteen days. The commission may in the meantime either rescind its order or amend same. This insures the introduction of complete evidence before the hearing of the commission in the first instance. Maryland adopted the Wisconsin method. In New Jersey and Massachusetts, the enforcement of the orders depends upon judicial process.

Such, in general outline, are the laws of the States having the public-service commission at the present time. As to the practical workings of these laws we have most conclusive evidence that wherever a commission has been established, and composed of competent men, the effect has been most satisfactory. The list which is given below of the subjects embraced in the cases of the commissions, and the cases chosen at random from the reports of the Wisconsin Commission to illustrate the thoroughly practical workings of the commission, will perhaps be of interest:

1. Reparation Claims. In the case of *Strange Co. vs. C. M. & St. P. R. R. Co.*, a refund from excess charge based on a minimum weight increased through inadvertence was ordered, and the charge subsequently lowered.

2. Applications by corporations for filing tariff schedules on less than statutory notice.

3. Applications for franchises.

4. Applications for authority to purchase stock of other corporations.

5. Applications for authority to issue stock and bonds.

6. Complaints of excessive rates. In the case of *T. J. Cunningham et al vs. Chippewa Falls Water Works and Lighting Company*, the complaint alleged excessive and exorbitant charges for water, gas and electric service. The value of reproducing the physical property, as determined by appraisal and as agreed upon by both parties, amounted to \$208,002 for the water plant, \$95,718 for the electric plant, and \$60,455 for the gas plant. Transcripts from the company's books since 1890 furnished ample data for the consideration of those factors affecting plant value, going value, working capital and accruing depreciation, and apportionment of expenses as enumerated and laid down in other decided cases. It was in this case held that the net earnings of the company could not be regarded as excessive or unreasonable. Changes in the rate schedules were ordered to avoid inequalities disclosed in the existing rates for electric service as between different consumer classes, however.

7. Complaints of service. In the case of *the City of Appleton vs. Appleton Water Works Company*, complaint was made that the machinery and appliances of the Appleton Water Works Company, at Appleton, Wis., were unfit, inadequate, and insufficient to furnish adequate fire protection; that its filters and reservoirs were insufficient and inadequate to furnish pure and wholesome water, and that its system and plant were inadequate for the need of the city and its inhabitants. The petitioner prayed that an order be made requiring the respondent company to make its service for fire protection and municipal and domestic use adequate and efficient. Upon hearing and investigation the Wisconsin Commission found that the respondent was not performing its public function, owing to the condition of its plant and system, and that the plant must be rebuilt and adequate facilities for a pumping and distributing system provided. It was ordered, (1) that the respondent should take whatever steps may be necessary for securing and maintaining permanently a reasonably adequate supply of pure, wholesome water; (2) that the respondent should make such additions, alterations, and repairs as would render its water works adequate and efficient for the purpose of supplying the municipality of Appleton and its inhabitants with reasonably adequate service; and (3) that the respondent should hold itself in readiness at all times to

comply with the provisions of the franchise granted to it by the City of Appleton respecting fire streams and fire service. Three months was deemed a reasonable time within which to comply with this order.

8. Transfers on street car lines.

9. Charges of discrimination. In the case of the Duluth Superior Milling Company vs. the Northern Pacific Ry. Co., the petitions alleging unusual and exorbitant switching charges between the tracks of the M. St. P. & S. S. Ry. Co., at Hill avenue, Superior, and the mill and elevator of the petitioners in the east end of said city, were answered by the order of reduction from \$3.00 to \$1.50, based on the holding, that notwithstanding that the grain switched was brought from points outside of the State, the switching at Superior was not inter-state traffic and that switching rates are within the jurisdiction of the commission; that, considering other switching rates, the rate complained of was unjustly discriminatory and was unreasonable for the services rendered.

10. Mergers of corporations.

11. Corporation reorganization.

12. Accidents.

13. Eliminations of grade crossings.

14. Discontinuances of railroad stations.

15. Restorations of discontinued service.

16. Limits of free delivery of express packages within the city.

17. Extensions of time for filing annual reports.

18. Compelling connection between telegraph and transportation lines.

From this list it is seen that the public is given thorough protection against waste in duplication of plants, against inadequate service and excessive rates, the stockholder against unwise issues of stocks and bonds, and other adverse action on the part of the officers and directors of the corporations; and the corporation itself against unscientific legislation, and hasty public opinion. Cases of every conceivable kind come before the commissions, and often an explanation to the complainant is all that is necessary. The maximum of justice to both parties

is done at a minimum expense, by means of scientific, non-partisan, unprejudiced, judgment.

The New York Commission of the first district claims in two years to have saved the railway companies and the people of New York City some \$3,000,000 in the prevention of accidents. The general opinion, almost without a single exception, seems to be that the commission has more than paid its way. Through the action of the commissions, duplication of plants has become a thing of the past, and all the advantages of monopoly are enjoyed without the corresponding high price to the public. The best service is thus afforded at the most reasonable cost. At the same time, the stockholder in the corporation is allowed a fair return on his investment. Discrimination is avoided. Transfers on street railway lines, and connections between telegraph and telephone companies, and steam railroads, where beneficial, are enforced; precautions for the prevention of accidents are caused to be taken, corporate reorganization is overseen, and all issues of stocks and bonds are passed upon with a view to determining the necessity and safety thereof, as well as the probable financial result; in short, the relations between the public and the corporations are made as pleasant as possible, and all friction that is unnecessary is avoided,—all disputes settled with celerity and small expense.

Corporations, in the main, meet the commissions in a very friendly spirit. Changes and readjustments to new conditions, of course, entail upon them some extra work and annoyance at the beginning; but, in general, it may be said that a spirit of co-operation usually prevails, with better and cheaper service for the public and reasonable and just profits for the corporations. Every complaint, whether large or small, has a patient and courteous hearing and an honest and able decision; the corporations are held to strict accountability and efficient service and capital honestly invested and capably administered finds that the law is its friend.

Having discussed the history and importance of the movement for the control by commission of public-service corporations, and having examined in some detail the laws and workings of five of the most typical States having such commissions, it now re-

mains to consider the question as to whether or not Texas needs a Public Service Commission.

The mere fact that the trend of development in a considerable number of States is toward this, is some evidence of our need. There is little need for regulation of other utilities than railways in communities where there is little urban development, but where there are in a State a considerable number of towns having a population of over 5,000, conditions are ripe for the development of complications between the corporations and the public which can be removed to best advantage only by a competent commission. In California, with 34 such towns, the people have seen fit to establish a commission; in Georgia, with 23 such towns, a commission has been found desirable; Kansas, with 23 towns of this size, also adopted the plan; Maryland has but 9 such towns and finds the commission necessary and convenient; Michigan, with 41 cities and towns of over 5,000, has a commission doing excellent work; New Jersey, with a commission, has 47 such towns and cities; New York has 80; Washington 12; Wisconsin 36; and Texas 40. Certainly, with such an urban population, and one that is increasing with leaps and bounds, Texas needs a public-service commission. In 1890, Texas had 20 such cities and an urban population of 349,511; in 1900 she had 27, with an urban population of 520,759; and in 1910, she had 40, with only a few less than a million urban residents,—an increase in urban population of approximately a half million!

It is a well-established fact that uniformity of control is essential to the proper performance of the functions of the public-service corporation. Where a corporation is dealt with hastily and without due consideration by small local units, it is not only wronged by unfair judgments, but by being dealt with without any consistency or uniformity whatever. Where a corporation is dealt with by an ever-changing legislature, composed of men who have no expert knowledge concerning the business, and with a mass of other matters to consider, it is again at a disadvantage. From the standpoint of the individual, speedy and fair judgments are rendered by a commission; while heated action, or action influenced unduly by the big business, is the result under the legislature, not to speak of the almost unavoidable delay and

the absolute lack of time for consideration of some less important cases.

It is furthermore highly desirable in any State that no duplication of plants be permitted, and that connections between telegraph and telephone companies, or between transportation companies, or similar co-operation between corporations of any kind, be forced where public convenience demands it. Monopoly in itself is not to be condemned. Monopoly may tend toward a reduction of the cost of production, and, under a commission, this reduction would redound to the benefit of the consumer instead of the corporation. With a commission to regulate, the public may trust important functions to monopolies; otherwise not.

From the standpoint of the investor and for the benefit of the corporations, wise control over issues of stock and bonds is highly desirable. Under a competent commission this wise control could be obtained. Needless to say, such control is essential to effective general regulation.

Under a commission, the public would be insured of reasonably adequate service and equipment, and all facilities. Public safety would be insured, and many accidents could be avoided through thorough investigation, and recommendations or orders as to means of prevention in the future.

For these and other reasons that might be cited, Texas seems to need a public service commission. And, on the basis of a careful consideration of the laws of other States concerning these commissions, and the workings thereof, the following recommendations are respectfully submitted for the regulation and control of public-service corporations of Texas:

1. The establishment of a Public-Service Corporation Commission, separate from, or combined with the Railroad Commission, composed of a sufficient number of experts, receiving salaries adequate enough to insure efficiency, and possessing the following qualifications:

- a. No connection with any corporation under their control.
- b. Receiving no gratuities of any sort from any such corporation.
- c. Appointed by the governor subject to the approval of the legislature, for a term of at least six years.

d. Removable for inefficiency, neglect of duty, or misconduct in office, after a proper hearing.

e. Either residents or non-residents of the State of Texas.

2. That the commission be given adequate control and supervision (including the power to require reports) over all common carriers (if combined with the Railroad Commission), and all companies for the conveyance of telegraph or telephone messages, or for the production, transmission, delivery or furnishing of heat, light, water, or power, either directly or indirectly, to or for the public, both as to:

a. Rates.

b. Service.

c. Equipment.

d. Stocks and bonds.

e. Franchises and accounts, including,

f. The power to compel physical connection between telegraph, telephone, or transportation lines.

3. That power be given to the Commission of Public Utilities, or the power of the Railroad Commission be extended to cover the valuation of all property of public utilities. Further, that power be given to the Commission to avail itself of any information in the possession of the State Board of Assessment.

4. The adoption of adequate means for securing public safety.

5. The insurance of adequate protection of the Commission from the great delays incident to court proceedings, and for the protection of the public in the meanwhile.

6. The passage of an adequate Public Convenience and Necessity law.

7. The passage of a law providing for indeterminate permits in Texas.

THE REGULATION OF RATES OF PUBLIC-UTILITY CORPORATIONS.

O. J. RUSHING.

In the first place, the differences between public-utility corporations and ordinary commercial enterprises should be recalled. "The former usually require a much larger investment in plant, equipment and other fixed property, which in turn means heavy annual charges for interest, repairs and maintenance. The conditions which surround the former are also of such character that the services which they render can usually be furnished at a much lower cost by one plant than by two or more in the same locality. The differences between them are not even limited to the facts named and to other facts of similar character, but extend to the principles of competition. In most of the ordinary commercial undertakings the expense can usually be stopped whenever competition has reduced prices below a profitable level. But this cannot be done in the case of public service corporations. The investment in these corporations cannot be withdrawn or often converted into other purposes. The interest and the maintenance charges go on at about the same rate, whether the plant is in operation or not. Hence it often happens that it is better for the owners that such plants should be kept in operation, even if they fail to earn more than the actual operating expenses. Duplication of such plants would be a waste of capital, whenever the services can be adequately furnished by one plant only. It necessarily means that interest and maintenance must be earned on a much greater, if not twice as great, an investment and that the actual cost of operation is likely to be relatively higher."¹

In addition to the preceding, there are at least four general principles that must be taken into account in considering the rates of any public-service company. These principles may be stated as follows:²

¹Report of R. R. Com. of Wisconsin, No. 64, p. 3.

²Jackson, D. C., "Is a Rational Basis Possible for Tel. Rates?"

1. The company has been granted privileges by the public for the accomplishment of some services for the people. These services should be such as the people and the times demand, and the company should charge prices which would be reasonable under such circumstances. It follows also that capital value is partly a gift of the people. Moreover, such privileges may properly be withdrawn upon failure to render adequate service.

2. After the company is incorporated it must not be continually disturbed by the public, but it must be allowed enough freedom to enable it economically to render the services for which it was organized; and it must be allowed sufficient returns for the capital invested, so that it will attract the best minds to the management, and maintain a stable credit with the investing public.

3. In a new and developing country a public-service company must be allowed, at least temporarily, greater returns from the capital invested when compared with the same capital invested in more stable conditions. This is needful in order that the company may secure the additional capital to meet the demands of the ever-increasing growth of the country.

4. Even in stable conditions a new corporation should be allowed greater returns from the investment than current interest rates, because the investors have undergone a great risk; but, after the company is well established and franchise rights have been secured for a long period of time, the returns should be expected to approach the current rate of interest.³

It is not to be inferred from the foregoing paragraph that new corporations should be allowed fabulous returns because of risks they have undergone in investing their capital. As a matter of fact, if the risks are too great, if the town is already served by one company that the new one would come in competition with, the city should not grant the franchise to the new concern. But still some inducements must be offered to investors, hence they must be assured of a greater return from their investment at the beginning. It adds momentum to the new business.

It has been said that a perfect rate schedule for any public-service corporation must be one which would return to the com-

³This statement may well be questioned. (Ed.)

pany the entire cost of rendering that service, including the operating expenses, repairs, depreciation, taxes, insurance, the general expenses of administering one company, and a reasonable return on the investment required to render the service. It can be seen at a glance that if we are to have a perfect rate for a company, we must have a good knowledge of what it costs to render the service. We must understand the depreciation problem, so as to know what amount to set aside for depreciation; and, the greatest difficulty of all, we must know as nearly as possible, the amount of capital required to render the service.

If accurate bookkeeping is in vogue, the cost of rendering the service, the actual running expenses including taxes, insurance, etc., will not be so difficult to get at. But, as it is at present, few companies keep an accurate account of the current expenses. Of course, a general account is kept, but the various expenses are not separated and pigeon-holed under the correct heads as they should be. The variable expenses, the fixed expenses, the insurance, the taxes, etc., should all be kept as distinct expense accounts, so that they may be correctly distributed to the various customers or service of the company.

One important item that has been overlooked by many companies in the past is a depreciation fund. It is the inherent quality of most physical property to deteriorate on account of the effects of use and the action of the elements. Ultimately it reaches a point of "decrepitude." Sometimes, too, the character of service becomes so far changed that a new set of machinery is necessary—the old has become obsolete. It is evident, then, that a fund must be set aside to replace worn-out property or obsolete property. Just how much shall be set aside each year depends upon the nature of the business and the conditions under which it serves. It has been estimated that three per cent should be set aside each year for this fund in the case of electric companies.⁴ But, as to establishing a general rule for the amount to be set aside for various kinds of businesses, a rule seems to be impossible. It will vary greatly according to the

⁴R. R. Com. of Wis., "In the matter of the application of the La Crosse Gas & Electric Co. for authority to increase rates."

nature of the business and the conditions under which it operates.

Besides this depreciation fund, there should be kept an adequate insurance reserve fund. The purpose of this is to cover any expenses which may arise due to some accident, such as a storm, or a fire.

Perhaps the greatest of all questions raised in this discussion is the matter of cost of plant. Shall we count the original cost of reproduction as the true principle? It seems that the best method is to take the cost of reproduction as most nearly approaching the true cost, for it is more nearly the cost of reproduction than the original cost (by original cost is meant not only the cost of original parts, but also of the improvements and the depreciation fund), that enters into the determination of the company's present value. The cost of reproduction is the amount a new company might give for the old—that is its true cost price.*

The question then arises, how are we to determine the cost of reproduction. This is an intricate problem involving the judgment of an experienced engineer. Of course, in newly constructed plants the original cost and the cost of reproduction will almost tally. This problem for the experienced engineer arises in cases of old established companies.

This principle of cost is illustrated from the report of the Railroad Commission of Wisconsin, in a case in which the La Crosse Gas and Electric Company asked for authority to increase rates. In dealing with this question, the commission undertook to estimate the cost in order that they might have a basis for the rates. From experienced engineers they learned that cost per kilowatt of installation, covering franchises, real estate, machinery, a high-grade distributing system, and complete equipment, ready to run, was \$330. Using this as a basis, the total cost was estimated to be about \$413,000. They further learned that the cost of installation per horse-power would be about \$250. Using this as a basis, the total cost was estimated to be about \$417,000. Another method of determining cost used by this

*The writer would, of course, take depreciation into account in estimating value on a cost-of-reproduction basis, as is implied in his discussion of depreciation. (Ed.)

commission, but counted less reliable, is the income method, i. e., assuming a relationship between known income and probable cost of plant, it was suggested that \$100,000 of investment might be allowed for every \$20,000 of gross income. This was considered less reliable because it reflects the skill and integrity of management rather than the cost of construction and equipment.

The above is cited to show the practical method of determining cost. Other items besides these were considered. A great part of the machinery had been replaced by new or had been repaired. So that neither the original cost nor the cost of reproduction would be adequate in themselves as a basis for computing the rates. The earnings and the operating expenses of the company for the past few years were also considered.

It was found that the average net earnings for the five years preceeding amounted to \$21,072, which equals 3 per cent for depreciation and 3 per cent for interest on a valuation of the plant of only \$351,200. They had computed the value of the methods above referred to, and found it to be at least \$450,000, hence they declared that the company was not being allowed sufficient returns upon their investment.

Electrical current is sold per kilowatt hour. This rate per hour differs very greatly as between different consumers. This difference is due to a difference in cost. "In industries requiring a large fixed investment the expense are of two kinds, those which do not depend upon or vary with the output, but go on even when production ceases, and those which depend upon the output and vary in proportion to it. For the same installation, or maximum demand of current, they are as great for the consumer who burns his lights only one hour per day as for the consumer whose lights are burning six hours daily. It necessarily follows from this that the amount of these expenses per kilowatt hour decreases as the number of hours used increases. The variable expenses on the other hand are about the same per kilowatt hour regardless of the number of hours used. These facts explain in part why the total cost per kilowatt hour of both of these classes of the expenses is less for the large consumer or long hour users than for the short hour consumer."⁵

⁵Wisconsin R. R. Com., No. 64, p. 18.

The electric business is rather peculiar in that the product has to be consumed as it is produced: it can not be preserved for some future use. The demand for electric current is greatest in the early part of the evening, but for the remainder of the time the demand is rather light. Since the current can not be stored, the capacity of the plant must be equal to the greatest demand made upon it. The average demand may be much lower than this.

There are in current use today three systems of rates, two of which take into consideration this difference between long and short hour consumers.

1. The "readiness to serve" system charges the consumer a certain sum per month on his installation, in addition to a specific rate per unit of current used. It is evident that this fixed monthly sum is intended to cover the fixed charges, and the rate per kilowatt hour is designed to meet the variable expenses. This system, when carefully worked out, seems to lead to correct results. The consumer pays the company for holding itself in readiness to serve, and in addition pays for the current according to the cost.

2. Another system, one which also tries to charge each customer according to cost, is the "maximum demand" system. Under this system there are two meter rates per kilowatt hour, one of which is higher than the other. The higher rate applies to the smaller consumers—those who use up to a certain amount per day. The lower rate is applied to those who use more than a certain amount per day. Of course this matter of classifying consumers into small and large is a relative matter. There might be great variance between different companies in classifying consumers. It appears that business houses that are open all night and churches and theaters might be put in one class, with the small business man and the residence in another. Still this would all depend upon the city and conditions. The difficulty here arises in the determination of the demand: Shall we take the total connected load,⁶ the average load over a period of time, or the maximum peak-load?⁷ In either case, it will be necessary to have demand meters. This will involve an extra cost as com-

⁶Total connected load means the capacity of the fixture.

⁷Maximum-peak load means the greatest amount used at any time in the past.

pared with a flat-rate system, but this would be a small item. Under this system some arbitrary adjustments have to be made. The short-hour consumer's rate may be so high that it will be prohibitory, hence it has to be adjusted to a certain extent so that it will not force some to quit using electricity. The cost to the short-hour consumer is greater because if all the consumers only used the current for this short period there would be just as much expense of running the plant, but the returns would not be sufficient, hence the cost for the short-hour consumer is greater per unit, and some adjustment of rates is necessary to induce him to take out lights.

3. The third system of rate making, and a system that is rapidly going out, is the "flat-rate" system. Under this system all are charged the same, regardless of the amount consumed. It is evident that this method is wholly unscientific. A modified form of the flat-rate system is to charge a uniform rate with discounts to the large consumers. This method is too largely arbitrary.

It must be understood that the general principles laid down at the beginning of this paper apply not only to electric companies, but to all public-utility concerns, including the telephone.

The problem of regulating telephone rates is one that has received less study than that of any of the public utilities. This is partly due to the complexity of the problem. In order to show this complexity three paragraphs may be quoted from the introduction of the report of the commission of engineers who in 1907 made a comprehensive report of the telephone situation in Chicago.

"A telephone company in a large city must face a problem in many respects more complex than that of any other public-utility corporation. The water department is called upon to sell a single commodity; namely, water, and at prices which are fixed with comparative readiness. The gas company also is called upon to sell a single commodity, metered for nearly every customer, and its conditions in dealing with customers are relatively simple. It may sell some additional by-products, as coke, tar, ammonia, but the quantities and market value of these are readily arrived at. The traction company has a more complex problem than some of the other purveyors of public utilities, but even here the price

paid by the several patrons is uniform and the substantial difference between patrons lies only in the lengths of the rides which they may choose to make.

The telephone problem, on the contrary, involves many complexities, partially caused by the relatively large number of classes of services which the telephone company must offer to its patrons for the purpose of fully developing the telephone service of the city, and partially by the intangible character of the electric medium with which the telephone business is carried on, the delicacy of the apparatus used, and the wide differences in the manner and extent of the use of the apparatus by the various subscribers.

"If a telephone company properly extends the telephone service in the city, it must be prepared to take care of the requirements of a range of patrons as wide as the interests of the city itself, including the largest business organizations, the hotels, the newspapers, the professional men, the small business houses, and the residences of all classes. It must provide apparatus for the service of each class of patrons which will enable it to furnish the service to each subscriber at an appropriate price within his means. It is desirable for the prices to be graded so that the largest user shall not pay less than his fair share of the expense of maintaining the traffic and the remuneration to the company for its investment, and equally so that the smallest user may get his telephone service at a price which is within his means and yet is reasonably remunerative to the company for its outlay."

Rates that are just to all must be based on the quality and quantity of the service rendered. Assuming the same quantity of service, it is certain that the cost of production will be the same to all parties demanding equal quality of service, provided the services are rendered at equal distances from the central. This difference in cost due to different distances from central office may be charged partly to fixed and partly to the variable cost. The equipment necessary for rendering the service of the same quality is equal to all equally distant consumers of the same quality. It is clear also that the cost of rendering services will depend upon the amount of services rendered. Some business

^aD. C. Jackson, "Is a Rational Basis Possible for Telephone Rates."

concerns use the telephones nearly every minute of the day. Here the quantity of services is great and the cost is greater. It is also true that the quality of services demanded by such concerns is different from that demanded by people of the residence sections. They demand a more accurate and speedy service.

Then it is evident that in any city or country the telephone customers must be classified. To the extent that the customers are accurately classified, the rates will be correspondingly accurate for the various classes. The general classification of customers is that which divides them into business and residence customers. These may be further classified, however, into one-party line, two-party line, and multi-party line.

The same as in the electric business, there are two kinds of investment: one may be called the "readiness to serve" investment, and is made up of the subscribers' station equipment, the drop wires, the lines from the subscribers' premises to the central office, switch boards, the answering equipment on the switchboard, and a small portion of the real estate, and also a small portion of the trunk line equipment which interconnects the central offices; the other may be called the "service rendered" investment, and it is made up of the remaining investment in switchboards, which comprises much the larger part of the switchboard investment, and the portion of the real estate and of the interconnecting trunk equipment not already allotted to the readiness to serve equipment.⁹

In a report to the Massachusetts Highway Commission, D. C. and W. B. Jackson brought forth some new methods of classification for the purpose of regulating rates. They proposed to establish the Metropolitan exchanges as one zone, and divide the suburban district into as many overlapping zones as there were central offices, each central office making the center for its zone. In these zones they provided for the measured rate system. The proposed rates for the Metropolitan zones for single-party business service were 960 messages for \$48, and 3 cents a message for all messages over 960 within the year; single-party residence

⁹Report of D. C. and Wm. B. Jackson to Public Service Commission of Maryland.

service, 840 messages for \$42, and 3 cents per message for additional messages within the year; two-party residence service, 720 messages for \$36, and 3 cents per message for additional messages within the year. A similar classification was made for the suburban zones.

All of this merely goes to show that it is necessary to have a thorough and systematic system of classification of the various consumers and of the cost of rendering the services in order to have just and equitable rates.

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APPENDIX

ORGANIZED LABOR AND ANTI-TRUST LAWS.

M. H. GRIFFIN.

By judicial decision, the right of wage earners to combine and quit work for the purpose of improving their conditions of employment has been established in America. Moreover, the fact of combination may not affect the legality of labor organization, even though there is some restraint of trade. The lawfulness of labor organizations as such has been further recognized by Federal enactment and State statutes. California, Colorado, New York, and Pennsylvania have such statutes. Thus it is seen that labor organizations are not to be classed with trusts, pools, and the like, as being combinations, as it were, inherently illegal. Indeed, there seems to be a tendency on the part of the state to diminish the natural inequality of capital and labor by prohibiting combinations of the former, and permitting combinations of the latter. Legislative expression of this intent does not, however, sanction interference with the lawful business of employers.¹ The right of action for damages in such a case is not closed by a statute expressly authorizing labor combinations, for such a law would doubtless be unconstitutional.² Labor agreements are still controlled by the same general principles of law as are association of capital, and more particularly associations of employers.

The status of incorporated and unincorporated labor organizations, at both common and statute law, needs to be examined in more detail. The powers of an incorporated union are those given it by its charter. Like any other corporation, it may be enjoined, and adjudged guilty of contempt of court and fined for violation of an injunction. It can sue and be sued, and is financially liable to the extent of its funds for its corporate acts. However, in the matter of taxation, State anti-trust laws, insurance laws, and Federal statute specially exempt labor corporations. Such laws are discriminatory in favor of labor organiza-

¹Clark, p. 216; Rept. Ind. Com., v. 17, p. cxxiii.

²30 Fed., 48.

tion, and a clause in a State anti-trust law exempting labor unions from its provisions, has been declared unconstitutional.³

Labor unions, however, are for the most part unincorporated. Since they are voluntary associations not conducted for profit, unincorporated unions are not subject to the regulation applicable to business associations.⁴ At common law they have no legal status or authority, apart from their members. On account of the partnership nature of voluntary, unincorporated associations of workmen, the property of members at common law may be attached in a judgment against the association, or the members and officers may be imprisoned for contempt of court in violation of an injunction.⁵

The extent to which the rules, by-laws, and constitutions of labor organizations may restrict the freedom of the individual, whether member or non-member, and thereby cause them to act as a combination in restraint of trade, as defined by common and statute law, needs to be examined.

The rules, contracts, etc., entered into by members of a labor union, if legitimate, are enforced by the courts. An agreement, however, to surrender industrial freedom to a labor organization is invalid. In the case of *More vs. Bennett*, 140 Ill., 69, a labor union was not allowed to enforce a fine against a member who had bid less for a piece of work than the rate fixed by the union. The court held there was not an actual monopoly of the class of services involved, but, so far as the agreement went, it was restrictive of competition and subject to the same legal objections as a more extensive combination.

Any rule of a union that prescribes the violation of contracts, or the refusal to handle the traffic of a certain railway, or that otherwise brings about a conflict with public policy, will be judicially condemned, even to the extent of dissolution of the offending organization. The courts declare that the rules of a union can not be in violation of the laws of the land.⁶

The closed shop has been held as an illegal combination in restraint of competition when it relates to employment of only

³*Cleveland vs. Anderson*, 92 N. W., 306.

⁴*Clark vs. Lathope*, 52 Mich., 106.

⁵85 Fed., 252; also 12 Fed., 23, and C., p. 221.

⁶*Clark*, above cited, pp. 227 and 229.

union men on public works, or even in private employment where the combination is *primarily* to prevent a non-union man from working.⁷ But several cases have upheld the closed shop when it is incidental to the object of bettering the condition of the laborers.

The more immediate cases wherein labor organizations have been declared to be restrictive combinations within the scope of anti-trust laws need now to be examined.

The purpose of labor unions to restrict employment to their own members, operates to exclude non-union men from employment. Thus unions are condemned on the ground that they are in restraint of trade. (Clark, p. 250.) In the case of *Kealey v. Fawcner*, 18 Ohio, S. & C., p. 498, the court held that if the union was essentially for the restriction of employment and of output, it could be disbanded as illegal. The rule of reason was applied by the court in the case of *Gotyow v. Buening*, 106 Wis., 1, when it was held that "All combinations in restraint of trade are contrary to public policy and illegal, unless they are for the reasonable protection by reasonable and lawful means, of persons dealing legally with some subject matter of contract."

The courts have held unlawful a combination of laborers to prevent the introduction of labor-saving machinery, or to secure the employment of members only, or to compel all employes of several employers to join a particular union, or to prevent the employment of others to take the place of workmen out on strike, or a combination to procure employes under contract to quit their employment, or in general a combination coming within the definition of a conspiracy.

Some State anti-trust laws, as those of Illinois and Nebraska, which expressly exempt labor organizations from their application, have been declared unconstitutional. The majority of States, however, do not exempt unions from the application of such laws. Most of the States having anti-trust laws simply declare the common law doctrine that combinations in restraint of trade are illegal.* Kansas, Oklahoma, Texas, Minnesota,

⁷Clark, p. 240; *Curran vs. Galen*, 152 N. Y., 33; also see 156 Fed., 62.

*The common law doctrine is that *unreasonable* restraint of trade is unlawful. Unless, following the Supreme Court in the recent *Standard Oil* case, the State statutes are construed to be subject to the "rule of reason," they go beyond a mere declaration of the common law. (Ed.)

Missouri, and South Dakota, are among the States having such laws. For instance, a Minnesota statute of 1905 (Section 5168) declares that no person or association shall enter into any combination in restraint of trade to fix prices, limit output, or restrict competition. The criminal penalty provided by these laws is usually imprisonment, or fine, or both; while the civil remedy is three-fold damages.⁸

The question as to whether labor unions, as such, came within the definition of combinations inherently illegal, can be answered in the negative. They are not strictly analogous to trusts and pools, which are prohibited by anti-trust laws. Although labor organizations are not illegal as such, yet the cases clearly show that a conspiracy or action in restraint of trade by means of boycott, or coercion in any way, can readily be fostered through labor organizations and their agencies. Where such is the case, labor unions and their members are civilly liable for damages; and for the commission of any overt acts, members are criminally liable. The courts have made the Sherman anti-trust law applicable to any union in the manufacturing and transportation industries, whether interstate or intra-state, which directly and specifically affects interstate commerce to restrain it.⁹

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⁸See Oklahoma Statutes, Secs. 8802 and 8805.

⁹Jr. of Pol. Econ., v. 18.

III.

Railway Capitalization

**THE PRINCIPLES WHICH SHOULD GOVERN CAPITALIZATION, AND THE
SITUATION IN TEXAS**

[The editor believes that few discussions of railway valuation and capitalization can be found which raise the important issues more directly and concisely than the following. Moreover, two of the writers speak with the authority gained by years of service as railway commissioners and as successful lawyers.

The reader will notice that three chief points of difference are raised: (1) the importance of capitalization in determining value, (2) the propriety of capitalizing "good will" and "established business," and (3) the relative merits of original cost of investment, and cost of production as bases for valuation. There is also a difference of opinion as to whether Texas railways are over-capitalized.

It is of interest that all agree that it would be well to amend the Texas stock and bond law so as to allow bond issues for capital improvements, subject to the supervision of the commission.]

RAILWAY CAPITALIZATION.

JUDGE N. A. STEDMAN,

Formerly of the Texas Railroad Commission.

Without perplexing this subject with the discussion of the difficulties involved in an attempt to measure rates with reference to the value of services rendered on the one hand and received on the other, it may be safely asserted, in the light of the adjudications, that the rates, as a whole, must, generally speaking, be sufficient, after deducting operating expenses, to yield a fair return upon the value of the property at the time it is employed for the public use. The maintenance of this rule is demanded by the dictates of justice, enforced by the constitutional limitation that no person shall be deprived of property without due process of law, or denied the equal protection of the law. The analysis of the constitutional mandate, as applied to a railroad corporation, is that since a corporation is an agency employed by individuals who, as a means of investing and receiving a profit upon their capital associate themselves as members of the corporation, the courts, looking beyond the name of the artificial being to the individuals whom it represents, regard the corporation created by such association as a person entitled to the protection of due process of law, and the equal protection of the law guaranteed to persons. And since the value of property, looked at practically, arises from the ability of its owner to derive profit from its use, a requirement that the owner shall not be permitted to receive such profit would be equivalent to depriving him of the property itself. Again, since railroad corporations are for the reasons already indicated, persons entitled to the same treatment that must be accorded to natural persons, the provisions of the constitution, prohibiting the denial to them of the equal protection of the law, requires that the investors in railroad property shall receive the same return that other owners of invested capital derive from their investments under similar circumstances.

It must not be thought that I am maintaining that the measure of compensation is to be a certain return upon the investment, for such is not my position. On the contrary, I contend that the

compensation shall be measured by the value of property, as distinguished from the investment in property, and I have merely referred to investors as a description of those whose capital has gone into railroad enterprises. Apart from other objections to the proposition that all that an investor in railroad property is entitled to demand and receive is a fair return upon his outlay of money, practically the present value of the property is preferable, as a basis for rates, for the reason that something like uniformity in the charges, to be assessed by railroad carriers in a given locality must be observed; and when companies are competitive such uniformity is a necessity. Though there may be discrepancies in the present value of different railroad properties in the same locality, the divergencies are nothing like as great as are those which exist with respect to the amount of investment, considering that the cost of construction, representing investment at a given date, differs largely from the cost of construction twenty-five or fifty years previously, by virtue of the changes in the prices of right-of-way, depot grounds, construction, material, and the labor applied to construction, and considering the varying degrees of appreciation or depreciation even in property acquired at the same time.* The courts, including the Supreme Court of the United States, have doubtless given more or less weight to this consideration in establishing the rule that the profit to which railroad companies are entitled is a fair return upon the value of their property at the time it is being used in serving the public.

Independently of the question of capitalization, there exists, in view of the principle stated, a good reason for ascertaining and declaring the value of railroad properties as the basis for rates. In this connection, it is to be observed that if, as is sometimes contended, the return of a railway company is to be estimated upon the investment as distinguished from the value, valuation is unimportant, since in that condition the desideratum

*This raises an interesting question, the answer to which is not clear. On either basis differences exist and the more favorably situated roads will receive a differential return. (Of course rates will be uniform for the same service, and the cost of performing that service on the poorest road must in the long run determine the minimum rate for all.) Would a differential based on difference in cost of construction not be more logical? Certainly it could be more easily obtained. (Ed.)

would be the ascertainment of the amount expended, irrespective of present value. It is settled by the decisions of the Supreme Court of the United States in the cases of *Smyth vs. Ames*, 169 U. S., 546, and *San Diego Land and Town Company vs. City of National City*, 174 U. S., 739, the doctrine of which has been repeatedly reaffirmed, that capitalization is not a governing factor in determining the reasonableness of rates.* This is necessarily true, assuming the correctness of the proposition that rates are to be adjusted with reference to a reasonable return upon the value of the property, unless capitalization and value should be equal to each other. The product of rates, if equivalent in amount to a reasonable profit on the capitalization, meets the requirement of justice and of the law, simply because the capitalization happens—it may be said accidentally—to correspond with the value of the property. The amount and market value of stock and bonds, constituting capitalization, are merely to be regarded as an evidence of value, just in the same way that the amount of a mortgage lien on real estate may be taken as a circumstance tending to indicate its value; and the evidential character of the amount and market value of stock and bonds is of the same influence and potency, whether they are issued with or without legislative restrictions upon their issuance.* It is to be observed that the importance of the amount and market value of stock and bonds as evidence has relation to the earning capacity rather than to the physical property of a railroad.** To illustrate, if a road is capitalized for \$1,000,000.00 and its stock and bonds command a premium of 50 per cent, making them worth \$1,500,000.00, the price they bring is influenced by the prosperity of the company, and such prosperity, in turn, is influenced by the net earnings of the road, or what is left out of gross earnings after paying operating expenses. If capitalization at the time of its creation is the same in amount as the value of the property, it may be readily perceived that a wide

*Cf. below, pp. 96, 113.

*While true in a sense, this statement may be misleading. Certainly the evidence is clearer and requires less analysis, etc., if the capitalization is known not to be watered. (Ed.)

**Of course the physical properties of the road contributes to the earnings and owes its value to the earnings. It is to be implied in the writer's statement that capitalization has a more *immediate* relation to earning capacity than physical plant. (Ed.)

gap may be produced within a few years. For example, railroad bonds are usually issued to run for long periods of time, ranging from twenty to forty years. Before their maturity the property upon which they are issued may, and usually does, undergo many changes. The course in this country has been for the property steadily to increase in value, so that it is not long before it becomes much more valuable than it was when the bonds and stock were issued.

If it be inquired why it is that the rates on the New York Central and Pennsylvania lines are less than they are in Texas, although the former has a far greater capitalization, the answer is that those lines exist and are operated in a territory enjoying a density of traffic greatly in excess of the density of traffic in Texas, and that density of traffic is the most important of all things as affecting the quantum of rates.

Since the foundation of railroad rates is the value of the property, and since the amount and market value of the stock and bonds do not constitute a part of the value of the property, but only supply circumstantial evidence of such value, and since such value exists even though stock and bonds have never been issued, and is provable by other evidence, in the absence of stock and bonds, it may be inquired what useful purpose does the restriction of capitalization serve. In my opinion, the limitation of capitalization is demanded upon grounds other than those sometimes assigned. The history of the enactment of the Texas stock and bond law affords evidence of a conception which generally prevailed in the country a few years ago in respect to the restriction of capitalization. Prior to the enactment of the Texas stock and bond law, many of the railroad companies of the country had insisted that they were entitled to earn an amount of money which, after payment of operating expenses, would be sufficient to pay the interest on their bonds and also a reasonable dividend upon their stock, and there were judicial expressions in some cases which countenanced that view. The doctrine not having then been established, that railroad companies are only entitled to earn a fair return upon the value of their property, irrespective of the amount of their stock and bonds, the advocates of the stock and bond law, not knowing what would be the decision of that question when it reached the Supreme Court

of the United States, felt that if capitalization could be confined to something like the value of the property, even if the contention, which had been made by some railroad companies, that they were entitled to earn interest on their bonds and dividends on their stock, should be upheld, the public would not, by virtue of the establishment of that view, be unjustly burdened with excessive rates. But, inasmuch as the claim of the railroad companies to earn interest on their bonds and dividends on their stock, regardless of value, has been repudiated by the Supreme Court of the United States and other courts of last resort, the reason we are considering as one of the grounds urged for the enactment of the Texas stock and bond law has lost much, if not all, of its force.

The reasons which exist for restricting the capitalization of railroad companies are, first, the protection of investors, and, secondly, the prevention of insolvency and, thirdly, the prevention of the diversion of earning that ought to be applied to the maintenance and improvement of the property, to the payment of interest and dividends upon excessive capitalization. Unless some limitation is imposed upon the issuance of both stock and bonds it is manifest that there may exist an opportunity to defraud persons who desire to invest in railroad securities. And yet, considering that the genius of our government is opposed to the paternalistic theory that would constitute the government the guardian of any class of persons, the regulation of the issuance of stock and bonds should have reference to the necessity of men's exercising their own judgment as to the value of investments within a considerable margin, and, accordingly, the government should frame its restrictive measures with the view only to the prevention of manifest fraud*. In other words, railroad corporations being the creatures of the State, and, especially, being engaged in quasi-public employment, the State, it may be conceded, should prevent them from issuing securities so grossly in excess of the real value of the securities as to operate a fraud upon the public. This view implies that there may exist such discrepancies between the face value of securities and

*This, of course, leaves open the question, what fraud is "manifest"? If the average investor is to be protected, the amount of judgment that can be counted on may be small. (Ed.)

their actual value as to be consistent with good faith and honest dealing, leaving investors to assume some responsibility as to the judiciousness of proposed investments.

In respect to the restriction of railroad capitalization for the prevention of insolvency, it is to be remarked that the failure to pay the interest on bonds may lead to legal insolvency, in the sense that the debtor is unable to meet its obligations as they mature. Hence, if a railroad company is so heavily burdened with bonded indebtedness that, upon a fair adjustment of rates, based upon the value of the property, it can not meet the interest on its bonds as it becomes due and can not make some arrangement by which indulgence may be secured, the result is a foreclosure suit with a receivership. Such a condition almost invariably operates to inflict serious injury upon unsecured creditors and other innocent persons. Undoubtedly the State should discourage practices that lead to such unfortunate consequences.

The third reason, which to my mind is the most cogent of all for restricting the capitalization of railroad companies, arises from the public interest in the prevention of the diversion to the payment of interest charges and dividends of earnings, which ought to be applied to the maintenance and improvement of the property. The temptation to let property run down and to refrain from needed betterments in order to pay interest charges and dividends is so strong that care should be used by the government to prevent it from confronting a railroad company. The deterioration of track and equipment and the omission to provide improvements are so manifestly opposed to the public good that the State should see to it that such deterioration and neglect shall not be occasioned by the over-issue of securities and the consequent temptation and necessity for withholding expenditures required for the maintenance and improvement of the property.

That restrictions upon the capitalization of railroads should be so framed as not to ignore the importance of the construction and equipment of a sufficient number of railroad lines to develop the country and handle the commerce would seem to be too clear to require any considerable elaboration of the proposition. It is equally well known that railroads will not be built except by

the proceeds of the sale of stock and bonds. Therefore, it results that unless there is liberality in the valuations of property for the issuance of stock and bonds, or unless a fair allowance is made for the discount at which they must be sold on the market, we can not expect railroad building upon a scale commensurate with the public needs.

It must be remembered that in the inception of railroad enterprises, securities must from the necessity of the case rest mainly upon the value of the physical property, with only such regard to anticipated earning capacity as the exercise of a cautious discretion may justify in view of the exigencies of the case. Of course, earning capacity can not be adequately known until after the roads are put in operation, have undergone the seasoning process, have established what is sometimes called "good will," and, in many localities, have even created commerce by stimulating the growth of various kinds of industry. After companies have established their earning capacity, they should be appraised at their value as going concerns, embracing such elements as may reasonably appear permanently to contribute to value; since, when a railroad company, by virtue of a reliable earning capacity—arising from its location, its connections, its terminal facilities, and the enterprises along its line—furnishes evidence of its value as a working whole, in excess of the right-of-way, prepared wood and bars of steel, it is plain that it is worth more than the mere physical properties of which it is possessed. The New York Central and Pennsylvania Lines have an enormous value, arising from their location in a territory furnishing a very dense traffic. In their infancy, located as they then were in a territory supplying a much smaller volume of traffic than at present, they were nothing like as valuable as they are today. Hence, it clearly appears that location in a highly developed territory is a most telling factor in respect to value, and yet location is not a physical thing, but rather one of the elements to be considered in determining the value of a railroad as a going concern.¹ The same thing is true of the principal railroad lines situated in what today are the most highly developed regions of this State. Their value has been

¹Compare the statement found below, p. 99. (Ed.)

much enhanced by the increased travel and commerce of the sections where they exist, consequent upon increase in population and increase in production and consumption. And still the best railroads in Texas, even if they were in every respect, regarded as physical structions, as valuable as the New York Central and Pennsylvania Lines, not having the density of traffic enjoyed by those lines, do not compare in value with those lines. Valuations for capitalization, based upon physical properties and such permanent elements of value as experience may show a railroad to possess, keeping in mind the considerations that weigh against over capitalization and at the same time keeping in mind the importance of stimulating railroad construction and equipment, do not appear to be subject to any sound objection.

The public interest does not end with securing the construction of railroads, for unless the tracks and equipment are safe and adequate for the demands of the public, the benefits derived from their construction fall short of what the public has the right to expect. Safety and expedition of travel on railroads are of the first moment, and but little less important is the safe and speedy transportation of the commerce of the country. To secure the necessary safety and speediness of movement of both persons and property, it is essential that railroad companies shall have safe roadbeds and safe equipment. To provide such roadbeds and equipment, it is necessary that money shall be expended, and for that purpose there is frequently no way of procuring the money other than by the issuance of bonds. To my mind there can be no reasonable objection to the issuance of such bonds agreeing in amount with the expenditures necessary to be made. On the contrary, not only the interest of the railroad companies but as well the interest of the public demands that the bonds in such cases shall be issued. To the extent that the Texas stock and bond law presents an obstacle to the issuance of bonds for improvement purposes, by all means that law should be so amended as to authorize, indeed I might say, to require, the expenditure of money for rendering the property adequate to the public demands, and that there should go with the law authority to issue the requisite amount of bonds.

The expenditure of money in the construction, improvement and equipment of railroads, commensurate with the demands of

first class service, is distinctly to the public advantage, both for the reasons already stated, and for the further reason, that the expenses of maintenance and operation bear close relation to the condition of the property. The correctness of this statement is readily apparent when it is considered that the tractive power of locomotives is much greater on low grade lines and on straight tracks than on high grade lines and tracks with curves. The expenditure of money in the reduction of grades and in the elimination of curves obviously, therefore, tends to the lessening of the expenses of operation. Again, it is obvious that a well ballasted railroad will stand wear and tear and will resist the action of rain storms much more successfully than those poorly ballasted; and the former character of roads can be much more cheaply maintained than those of the latter kind. It is plain that well constructed and strong bridges, adequate to resist the action of floods, are much more desirable than those of less strength and cheaper construction in view of the heavy expense of replacement in the event of destruction. The same considerations apply with greater or less force to equipment. The avoidance of accidents, by reason of good roadbeds and good equipment, is plainly in the interest of keeping down operating expenses. Inasmuch as transportation charges are in a great measure influenced by the expenses of maintenance and operation, it is entirely clear that the necessary effect of good construction and of improvements, bettering the condition of the property, as well as of superior equipment, is ultimately to cheapen transportation charges.

I am impressed with the conviction that, if there is any objection to such liberalization as I have suggested of the stock and bond law, looking to the encouragement of railroad building and the improvement and betterment of the property, it would be removed by the incorporation in the law of a provision, empowering the railroad commission to exercise supervision and control over the appropriation by railroad companies of the proceeds of the sale of stock and bonds to the legitimate purposes of the company issuing them. Starting with the idea that the amount of stock and bonds in the aggregate should bear some reasonable relation to the value of the developed property, without exacting mathematical conformity, if the Railroad Commission should

be clothed with authority to see that the proceeds of the sale of stock and bonds are expended in payment of obligations incurred for construction or in the acquisition of property, or in the improvement of property, the public interest would be sufficiently safeguarded. If existing legislation does not sufficiently secure obedience to the constitutional mandate that no corporation shall issue stock or bonds except for money paid, labor done, or property actually received, there should be coupled with the provision already suggested, another provision rendering the constitutional requirement effectual. The two provisions, in connection with authority vested in the Commission to restrict the amount of stock and bonds within reasonable limits, would so safeguard the public interest that no apprehension could reasonably be indulged that the liberalization of the stock and bond law demanded by the considerations already presented would be hurtful to the public.

RAILWAY CAPITALIZATION IN TEXAS.

R. F. HIGGINS.

1. *Overcapitalization and Its Evils.*

An understanding of what constitutes overcapitalization involves a knowledge of what constitutes real capital on the one hand and the capitalization on the other. To say that real capital equals the value of the property would be correct yet far from the whole truth, for valuation of property is the one great problem with which we are concerned. Before we can assign to property its proper value, we must first determine what items constitute that property, whether it consists of the physical assets alone or the physical assets plus the intangible. This being done, we must then determine what standard of valuation we should apply to the property so constituted, whether the equitable basis lies in the cost or in the earnings. The application of these conclusions to the net assets of a given concern would give us the real capital.

Capitalization, on the other hand, is much easier of determination, for it is generally recognized in the case of railways to be the par value of stocks and bonds. There is some difference of opinion as to whether or not bonds should be considered in determining capitalization, yet they truly represent an investment, and the weight of authority supports the contention that they must be considered together with stocks as constituting capitalization.

These two figures properly determined, furnish the basis for determining overcapitalization if it exists. If the par value of stocks and bonds exceeds the real capital, overcapitalization is said to exist, and the difference between the two is called "water." Ripley defines stock-watering as "an increase of nominal capitalization of a corporation without a commensurate additional investment of funds."¹ He says it generally assumes

¹Ripley, *Polit. Sci. Qr.*, Mar., 1911, pp. 98-121.

the form of an outright stock or bond dividend. This brings up the question of why stock is watered.

Some of the evils of overcapitalization may be briefly suggested. They may be considered under two heads: evils to the investor and evils to the public. Aside from the fact that overcapitalization may lead to undue speculation whereby the officers and directors may become so imbued in the speculative spirit as to let the business totter and fall, or that in cases of already excessively capitalized concerns contingencies may force them to the wall because of inability to secure additional funds, the evils to the business and management itself may be subordinated to the greater evils to the investor and the public. The great evil to the investor is the speculative nature of securities attendant upon overcapitalization. The investor is not only unable to anticipate the wisdom of his investment, but usually gropes in the dark when attempting to familiarize himself with the value of the securities. The evil mentioned as affecting the management itself and consequently the business works a detriment also to the investor. By far the greater evils, however, are those which affect the public. These evils are not to be distinguished from the foregoing, but additional ones must be considered. The foremost of these is the evil of a corporation striving to pay dividends on watered stock, for which the public must pay in higher rates or poorer service. This attempt to pay dividends on watered stock, or rather to pay normal dividends on an excessive capitalization is sometimes an unconscious one, but often it is a case of fraud upon the public. Corresponding to this evil, and resulting from an attempt to pay dividends on overcapitalized roads, is the resulting evil of inadequate service and the failure to make much needed extensions.

But one must not think that overcapitalization is always an evil. It is rather a doubtful device, sometimes beneficent, but more often accompanied by evil results. Professor B. H. Meyer is of the opinion that it has often proved beneficial, especially in the building of new roads and the initiation of many of the great enterprises of our country today.² Judge Knapp of the In-

²*Senate Hearings on Railway Rates* (1910), Vol. III, p. 2513.

³The same.

terstate Commerce Commission doubts if it is an evil of alarming proportions, and believes that attempts to keep capitalization down to actual value might lead to ruinous consequences, especially in initiating new enterprises.³

Closely connected with this point is the evil that may result from undercapitalization. In the case of the Standard Oil Company, we have an instance of voluntary undercapitalization. The evil here is that by the excessive undercapitalization the Standard Oil Company is enabled, by keeping out a large body of investors, to effect a stronger combination than they could otherwise do. Moreover, it makes fluctuations in the values of the stock more violent. Greater evils, however, arise out of undercapitalization enforced by law. The strongest argument against too strict regulation of capitalization leading to undercapitalization is that it may prevent new enterprises, further construction of railways, and the addition of needed extensions.

It will be remembered that the determination of real capital was mentioned as the one great problem with which we are concerned. Before any attempts can be made to regulate the issuance of securities for purposes of preventing overcapitalization, the value of the property upon which these securities are issued must be known. No intelligent regulation can result from approximate valuations. They must result from a combination of engineering skill and a knowledge of economic laws. The magnitude of the problem is suggested by the widely divergent opinions as to the items of valuation. Shall we consider the intangible elements, or only the physical properties? Is it right that we should capitalize the judgment and foresight of the promoter? Have the railroads a right to earnings on the value of their property on the basis of what its reproduction would cost? If not, then can the public forbid them to earn a profit on the total original cost of the property in case it exceeds the cost of reproduction? These are only a few of the many mooted questions which the economist must determine, and then it remains for the skill of the engineer to apply the standard.

Before entering upon a discussion of the different criteria of valuation, we must first distinguish the purposes for which valuations are made. In the case of *Smyth vs. Ames*, the Federal Supreme Court held that the amount of outstanding stocks

and bonds should be considered as one element in determining fair value for rate-making purposes.⁴ It followed that the States must control the issuance of securities, or rate-making would be a farce,* and to do so they must know the value of the property upon which the securities are issued. Another purpose, and the controlling one in Texas, is to prevent the evils mentioned above as growing out of overcapitalization. Valuations are also made to determine a basis for taxation, but this brings up a distinct problem, and must be excluded from this paper. With these purposes of valuation in mind, let us examine the standards usually suggested by the best writers on the subject.

2. *Standards of Valuation.*

Generally speaking, four rather distinct standards are suggested: original cost, cost of reproduction, earning capacity, and market or present value. Taking these up in the order named, what constitutes "original cost?" By original cost is meant the cost of construction of the physical properties in the beginning plus the cost of each additional extension. Much confusion results, when one attempts to discuss the merits of this as a standard of valuation, from the failure to get a proper idea of what items are to be included. Practically all writers exclude the intangible elements, but there is a respectable difference of opinion as to what tangible elements should be included. Shall we include land grants or rights of way given to the companies as a part of the original cost? In dollars and cents these items cost nothing, and can not be considered a part of the original outlay, yet they were given in many instances for a real consideration—the risk of pioneering and the like—and it seems only right that in most cases they should be considered as an item of original cost. Another question arises in connection with discounts, early business losses, and the cost of building up the business. If the public demands the building of new roads, and the securities can only be sold at a discount, it seems clear that a reasonable discount may well be considered. The same is true of early losses and the cost of building up the business. These items are

*Cf. above, p. 85. (Ed.)

⁴*Smyth vs. Ames*, 169 U. S., 466.

often unavoidable, and if we expect men to finance new enterprises for a profit, we must allow them to capitalize these items.⁵ This view is held by Mr. Erickson of the Wisconsin Commission, and seems well founded. The difficulty arises when we allow for discounts and losses on the one hand, and allow for value of land grants and rights of way given on the other, for it will be remembered that the latter items were permissible only as a risk for the former, and of the two—where both exist—the former would seem preferable. Original cost, then, as usually worked out, would include the cost of construction, discounts if normal, early losses if reasonable, and legal and engineering expenses.

A fundamental objection to the original cost has been foreshadowed in the preceding paragraph—the difficulty of obtaining the cost. Much will depend upon the availability and correctness of the construction records; and they are not only often unavailable but may sometimes be incorrect, especially in cases of fraud. Even though this objection, however, does not prove fatal, it is unsatisfactory from an equitable standpoint.

The cost of terminal facilities illustrates this point. Perhaps the value of the terminal site has increased many times, yet by this standard it must not be capitalized. A new road could purchase the same site, and capitalize at a much higher rate. Furthermore it excludes many intangible elements which, as we shall see later, might well be considered in determining valuation. It is not denied that original cost may be modified so as to consider each of these items, but we are considering it as usually interpreted.

Another standard mentioned was “cost of reproduction.” This, like original cost, excludes intangible elements, and is found by determining what the different items as existing now would cost to reproduce at present prices. These items would consist of cost of labor, material, excavations, rights of way, and all materials and physical properties necessary for construction. In this instance the same difficulty in determining value is not met as in original cost, and aside from fluctuations in the price of labor and materials, the cost is fairly easy of determination.

⁵Halford Erickson, *Regulation of Public Utilities*, p. 54.

The proper method seems to be to take the average cost of these items under normal conditions. It has been argued against cost of reproduction that it is a mere matter of opinion, and the different estimates of the construction of the Panama canal were cited to sustain the point.⁶ While there is some basis for such reasoning, the analogy does not appear to be very perfect. In the case of the Panama Canal and other new enterprises, unforeseen obstacles and additional items enter in to change the original estimates. In the case of railway construction, the estimates are not only based upon the experience of construction of other railways at the present time, but upon every item and obstacle in the construction of an already completed railway. No one can contend that this would be intruding on original cost, for if cost of reproduction be taken as the standard, we must grant every possible means of procuring that cost.

As indicating further limitations on the cost-of-reproduction basis, the distinction between cost of reproduction and "present value" must here be made. The former makes no allowance for seasoned roadbeds, nor does it discount depreciation. It can not be said that one offsets the other, for there is no relation between the two standards. This omission is a fundamental objection. The most potent objection, however, is that brought out in the case of "Metropolitan Trust Co. vs. H. & T. C."⁷ In this case it appeared that the valuation of the Texas Commission had been based largely upon the cost of reproduction, and that no consideration had been given to certain intangible items which the court held should be considered. The court held that, "the valuation of a railroad, like that of any other property, may be a matter of growth, and its location, good will, and established business were elements to be considered in determining such value. It may have been constructed at a time when the condition of the country which it transverses was such as to give no reasonable expectation of immediate profitable earnings, and have been maintained and operated for years without profit to its owners, who may legitimately have relied upon future development of the adjacent territory, and of traffic, to render the property eventually valuable and profitable, and in such cases a

⁶*Amer. Econ. Assoc. Pub.* (1910), p. 198.

⁷90 Fed., 683.

mere cost of replacing the physical structures of the road is too narrow a basis upon which to determine its value as the capital on which its owners are entitled to earn dividends, and as the basis for fixing rates by the State." Because of this and other decisions, and because of the growing belief in the justice of capitalizing certain intangible elements, cost of reproduction as a single standard of valuation has largely lost its popularity.

It is necessary, in this paper, to mention earning capacity for purposes of refutation only. Mr. Erickson of the Wisconsin Commission defines earning value as "the amount upon which a plant will earn a given return." "Thus," he says, "with a rate of return fixed at 8 per cent, a plant with net earnings of \$100,000 per year would be regarded as worth \$1,250,000."⁸ This method of valuation is strongly urged by business men, and for purposes of protecting investors in securities seems adequate. Bearing in mind the fact, however, that we are dealing with a public-service corporation subject in its nature to control of rates by the government, and that one of the objects of valuation is for purposes of rate-making, we have the ridiculous procedure of basing rates upon a capitalization which is itself largely determined by those rates. To say that the correct procedure would be to determine the valuation for rate-making purposes by other standards, and then to capitalize the earnings upon those rates, would admit the necessity for other standards. To say that the location of the road with reference to traffic and population, the nature and permanence of these items, the permanence and nature of the contributing industries are elements that determine earning capacity, and should be considered might be just and right, but these are items that might be considered in connection with other standards of valuation, and do not include the essential element of earning capacity, in that a change in rates might lower or raise the standard based upon those items.* In that earning capacity is fallacious as a standard for rate-making purposes, and since the necessity for some other criterion for determining rates exists, earning capacity as a solution of this problem must be abandoned.

⁸Halford Erickson, *Reg. of Pub. Util.*, p. 56.

*Cf. above, p. 89.

Closely related to, and in fact dependent upon earning capacity, another criterion has been suggested, namely, market value. This criterion would take into consideration the seasoning of road beds, depreciation, the present value of real estate and terminal facilities, and those intangible elements which contribute to the worth of the company as a going concern. In so far as these items are considered, market value may well be taken as the standard of valuation, but we again meet the wall when we consider this value as affected by earning capacity, or the rates which the company is allowed to charge.

It is evident that no one of the preceding bases can be taken alone as a method of valuations. What is the solution? In the case of *Smyth vs. Ames*, the court held that rates should be fixed with reference to the fair value of the property and services rendered, and suggested for consideration in reaching fair value, cost of construction, amount and value of stocks and bonds, earning capacity, and operating expenses.⁹ In the case of *Metropolitan Trust Company vs. H. & T. C.*,¹⁰ the court held that location, good will, and established business were elements to be considered. The noticeable part of each of these decisions is the clear recognition of the intangible elements.

Confusion arises when one attempts to draw the line in all cases between the tangible and intangible; for, take the judgment of the promoter, classed as an intangible element, and one finds that the advanced price of real estate, the physical characteristics, the density of population and the favorable location of the road in general, may be attributed in part to the foresight and judgment of the promoter, while on the other hand these items increase the value of and become an integral part of the physical properties of the road. Who would contend for capitalizing such items as foresight in selecting a site for a mercantile establishment when it is reflected in the value of the site itself? This illustrates the danger of duplication. The question is, what intangible elements deserving of recognition are not already reflected in the value of the physical properties? Generally speaking we might answer, those items peculiar to that particular road, such as good will, established business, and

⁹*Smyth vs. Ames*, 169 U. S., 466.

¹⁰90 Fed., 693.

effective management, none of which are reflected in the physical value of the properties. On the other hand, it is clear that no list of items can be set off as always representing intangible elements which ought to be capitalized, and that each case must largely stand on its own merits. Take the case mentioned of the judgment or foresight of the promoters. If the road extended through a country equally populous through its route and with industries well distributed, the judgment would be largely reflected in the value of the real estate and structures. On the other hand, if the road lay across a barren prairie, but between two good points and carried a very heavy through traffic, the judgment would receive very much less expression in the physical properties by reason of a cheaper right of way and station facilities. If in each instance the earning capacity were the same, the writer sees no reason why judgment might not be an item of value in the latter case while not in the former, as distinct from the value of the physical properties.*

With this precaution in mind, let us next consider the equity of capitalizing these intangible elements, not reflected in the value of the physical properties. Is it right to capitalize good will and established business? The courts have so held, but were the courts right? In the ordinary competitive business these items are frequently represented in business transactions in dollars and cents, and not infrequently to a greater amount than the physical properties. They originate in intellectual ability and honesty and count for much in the business world. They are items of value to any concern regardless of its nature, and are more or less permanent assets, and it ought to be admitted that any item of value constituting a permanent asset should be included in a valuation.

*Judgment if it is an element at all must be an element in both cases, though it may be a negative element. If earning capacity is the same, is judgment not the same? In one case the costliness of the structure has to be considered by the promoter; in the other case there may be more risk of not securing traffic, etc.,—merely the factors in the judgment differ. An element of circularity appears in the proposed judgment basis, for judgment could "reflect" no value except as earnings come in, and these earnings can not be made a basis for capitalization for rate-making purposes, as the writer justly maintains. Clearly, some further analysis is necessary here. (Ed.)

Effective management is likewise an item of value but far less permanent, and also reflected to a large extent in the established business and good will of a corporation. Hence, for practical purposes, because of the difficulty of valuing management, because of its more or less shifting nature, and because of the liability to duplication, we can not uphold a contention that this should be considered an item of valuation, though such an item may affect the commission's decision as to the equity of existing rates.

The conclusion as to the intangible elements is that the judgment or foresight of the promoter is so interrelated in most cases with the physical properties, and has a value so difficult to obtain and so remote as an item of cost in others—it being true in those cases where it might of right be an item of value independent of the physical properties that the cost of right-of-way and grounds would be comparatively small—that for practical purposes, and as an independent intangible element, it may be excluded. It has been indicated that “effective management” may be excluded as a distinct item of value for the reason set forth in the preceding paragraph. There remain but two intangible elements—aside from franchises in cases where they were paid for—that ought to enter into all valuations: good will and established business.

The question of making physical valuations is no less intricate. “Fair value” is to be the standard, but how is this value to be determined? As generally stated in distinguishing cost of reproduction from present value, the latter makes allowance for seasoned road beds, and discounts depreciation in the absence of a depreciation account. This seems to be the nearest approach to a correct criterion, but the question of what items are involved remains. The following have been considered by the various writers on the subject: interest during construction, the necessary discounts in the sale of securities, “carrying charges,” in addition to those items, such as labor and materials, and legal and engineering expenses, that would naturally be charged to the construction account.

Upon the first item most writers are agreed that interest during construction is a necessary outlay, and properly chargeable to the construction account. Some commissions have seen fit to

allow a certain fixed per cent and there are frequent objections that the amount allowed is inadequate. This item can be obtained with more accuracy in each case by making such allowance as the construction of the road will bear out, and such a policy being more accurate is therefore more just, if the circumstances in the construction are normal.

Should discounts be allowed? In the case of a newly constructed road without any good will or established business, discounts on the securities are necessary to make them saleable. These constitute an actual outlay, and may be said to represent the good will and established business that will come with years of operation. We would conclude, then, that when a road has been in operation for a series of years, with the intangible item of good will and established business appearing in its valuation, that discount may be dropped as an item in valuation.* But in the case of a new road, without intangible items except perhaps its franchise, we have seen that as a necessary outlay it must be considered if further construction is to be fostered; and also that as an item representing the intangible items of value that will come after a few years of operation, it is a just item of value.

The item "carrying charges," which consists of interest on investment and depreciation after the construction of the road prior to the time it is self-sustaining, is readily seen not to occur in the valuation of a new road. This item is usually a necessary outlay, but it is not only represented by discounts on securities, but is also undergone with the expectation of future earnings. Then, when either established business and good will or discounts are considered, it would be duplication to allow for carrying charges also.

To summarize the foregoing conclusions, we find that we have two quite distinct standards for determining "fair value" according to the circumstances of each particular case. If the road to be valued is a newly constructed one, we might designate the standard as original cost with due consideration to the following items: interest during construction, discounts on securities, legal and engineering expenses, and the actual cost, in the absence of fraud, of all materials, structures, and labor, as

*I. e., in case of re-valuation. (Ed.)

determined by the engineer. In revaluing old roads the above standard would be modified by dropping the single item, discounts, replacing it with the intangible items, good will and established business, and allowing for seasoning of road beds and discounting depreciation, adding thereto the increase in the value of the properties due to increased price of depot grounds, right of way, and terminal sites, and the addition of facilities such as new equipment not considered as replacement, and other items properly chargeable to capital account. Presuming this to be the correct standard for the valuation of railways, it remains briefly to compare this with the standard used in Texas.

3. Texas Railways Not Overcapitalized on the Whole.

The ultimate purpose of this paper has been to determine whether or not overcapitalization exists in Texas today. To do this it has been necessary to do more than merely compare the Texas Commission's valuation with the amount of outstanding stocks and bonds, for the question would remain unanswered unless it were known whether or not these valuations were correct. Presuming that the conclusions reached heretofore in this paper are correct, it is found that the valuations of the Texas Commission are inadequate as a basis for determining the real status of Texas roads and this for two reasons: most of the valuations were made seventeen years ago, and if they were correct then they have not been maintained so; and second, the basis for such valuations is incorrect according to standards for valuation arrived at above.

The first mentioned reasons—that the valuations are out of date—suggests a serious omission of the Texas Stock and Bond law. The Commission, in its annual report, calls attention to the fact that, “The major portion of the valuations here published are the original valuations of the Commission which were made many years ago, and do not represent what the Commission believes to be the value of the properties today.”¹¹ The assessed valuation of the Fort Worth and Denver City per mile of line is \$33,231, while the Commission's valuation, made in 1884, is only \$12,709. The average assessed valuation of all roads per mile of line is \$24,677, while corresponding valuation of the

Commission is only \$18,518.¹² Such a discrepancy, due mostly to the failure to revalue the roads, largely defeats the purpose for which valuations are made, that purpose being in part to afford a basis for rate-making and to give correct information to the prospective investor. The Commission adds, however, that it stands ready to correct these valuations when the occasion demands, the occasion being the time for refunding bonds. But upon what basis are these revaluations, so-called, to be made? The Commission will simply add to its original valuation, expenditures chargeable to capital account, which is not in fact a revaluation. To be such it must give due consideration to the present worth of the road, and this it does not do, no consideration being given to the increased price of real estate, including rights of way, depot grounds, and terminal sites. The Commission claims it has no other authority under the law to make periodical revaluations of railroads. If not, the law should be so amended as to confer upon it the authority as well as the means to keep up these valuations.

The second objection to the valuation of the Texas Commission is the improper basis upon which its valuations are made. Bearing in mind the preceding conclusions, the objections are best disclosed by a brief study of the Texas method. Under the Stock and Bond law the Commission is authorized to determine a "reasonable value" of the road "including all the franchises, appurtenances and property."¹³ By authority of this provision the commission has adopted "cost of reproduction" as the standard for original valuations. The Commission allows 5% flat for interest during construction, 5% for legal and engineering expenses, and 6% for franchise values. The latter item is said to represent the difference between the value of the physical properties and the value of the road as a going concern. In case of revaluation, "When the occasion demands," there will be added to the original valuations all expenditures chargeable to capital account according to the Interstate Commerce Commission classification.

It will be remembered that two standards were constructed above: the first for newly constructed roads, and the second for

¹²Nineteenth Annual Report, p. 489.

¹³Nineteenth Annual Report Texas Com.

the revaluations of old roads. In the first it was found that original cost with due consideration to discounts, legal and engineering expenses, and interest during construction, these items being reasonable, was the proper method. To adopt this method Texas would have to make the following changes. Instead of allowing flat rates for interest and legal and engineering expenses, the actual cost of these items, in the absence of fraud, should be determined; discounts that were necessary in the financing of the road should be allowed; the franchise item, unless such franchise was paid for by the road, should be dropped; original cost, and not cost of reproduction, should be the determining factor. The Commission notes that the item "franchise value" represents the increased value of the road as a going concern, and it seems to be a rough recognition of the intangible element. Because of the absence of good will and established business in a newly constructed road, and because of the proposed periodical valuations, the writer would exclude the intangible element from this valuation. There is no such thing as value to a constructed railroad unless it is to be a going concern, and the item in such a valuation is objectionable. To illustrate the difference between original cost as proposed and the cost of reproduction. Take an instance given by a Texas railroad man in the construction of a bridge. The bridge was twice unavoidably destroyed by floods of the Trinity river, and while three bridges were actually built, the Commission allowed the value of only one.¹⁴ The writer does not contend that in the above instance, nor yet in most instances, allowances should be made for such contingencies, but where such accidents occur in the normal construction of a road and constitute an unavoidable outlay of the corporation, in view of the ever increasing value of property, they may in justice to all parties be considered for purposes of capitalization.

Considering the revaluations of old roads, we find the Texas method utterly worthless. It may not even approach a correct value. The first move must come from the Legislature authorizing the Commission to revalue at certain reasonable periods of time, and placing the means in their hands whereby the valuations

¹³Art. 4584c, R. S.

¹⁴Duff, R. C., *Speech on Stock and Bond Law*, p. 17.

may be made without relying so much upon the statement of the road. From the original valuation would be dropped the item of discounts, which would be replaced by the intangible elements, good will and established business. The seasoning of roadbeds, increased value of real estate and properties, increased facilities in the way of structures and equipment, and depreciation, are all items to be considered.

By these changes, thus conforming Texas valuations to what seems a correct value, the public would have a reliable basis for determining the value of a corporation's stock, the railroads would have a just value upon which to demand a right to earnings, and the Commission would be safe in abiding by such a valuation in the making of rates and the regulating of security issues.

It is extremely difficult, in fact impossible, to say what proportion of water, judged by the actual value of the railroads, exists in Texas today. The valuations of the Commission are clearly inadequate; the assessed value is only approximate; and the correct standard, according to the conclusions of this paper, has never been applied to Texas roads. If one compares the Texas method with the proposed standard for valuations, it readily appears that, since additional items are considered under this proposed plan, the Texas valuations, even if they were brought up to date, would be less than the real value of roads at the present time. Since the Commission's valuations are not present valuations, however, some other basis, giving what purports to be the present value, must be sought for the purpose of forming an opinion. However inaccurate and approximate, there is only one such basis—the valuations assessed for taxation. The writer gives below some figures which tend to show what he believes to be true, that the valuations of the Commissions, if brought to date, would exceed the assessed valuations.

In the years 1908, 1909, and 1910, four fairly typical roads, having an aggregate of 899 miles, were valued by the Commission. The average value per mile as given by the Commission was \$21,063, while the corresponding assessed valuation was \$12,142. Taking the only two roads of any size valued by the Commission in 1911, the St. Louis, Brownsville and Mexico and the International and Great Northern, as typical, it is found that

the average value per mile according to the Commission was \$26,477, while the corresponding assessed value was \$19,763. The writer sought the typical roads that had been most recently valued, and found in every instance that the Commission valuations exceeded the assessed valuations.

These figures tend to show, that although the assessed valuations are only approximate, they are doubtless less than the valuations of the Commission would be if a revaluation of all roads were to be made now. Accepting this to be true, one can approach more accurately the real value of Texas roads; for as already shown, their real value exceeds the Commission's valuations at the present time, and the Commission valuation, if a revaluation were made, would exceed the assessed valuation. From this, the writer is fairly convinced that the present value of Texas roads exceeds by a fair per cent the present value assessed for purposes of taxation.

The average assessed value per mile of Texas roads in 1911 was \$24,677. The par value of outstanding stocks and bonds per mile at the same time was less than \$9,000 greater, or \$33,475. If the preceding paragraph be accepted, one must conclude that there is no great amount of "water" in Texas railway capitalization on the average. At least the "water" is much less than would be indicated by the assessed value. The foregoing is reinforced by a comparison with railway valuation in other States. Wisconsin has estimated the cost of reproducing her railroads at \$41,811 per mile, Minnesota at \$54,201, and Washington at \$64,343.¹⁵ Such comparisons are by no means conclusive, for the conditions of construction vary with the locality, but the density of population and the nature of the land in the above States makes them comparable to Texas. Even though one considers certain items, such as cheaper terminal facilities perhaps, that would make construction of roads in Texas cheaper, he must be struck by the vast difference between the above figures and the estimated cost of Texas roads.

Such comparisons as have been made and such statistics as have been considered in the preceding paragraphs certainly tend to show by a preponderance of evidence that water has been

¹⁵*Jr. of Polit. Econ.*, June, 1911, p. 452.

squeezed out of the average railway capitalization in Texas. The writer is careful to point out that, since some Texas roads are more highly capitalized in proportion to their value than others, and are perhaps overcapitalized, that others, by reason of this fact, have already reached the stage of undercapitalization, whence other evils arise.

Bearing in mind the original purpose of the Stock and Bond law and the policy of the Commission to "squeeze the water" out of Texas railway capitalization, if there is a single conclusion above others in this paper it is that the time has now come for the policy of Texas with reference to her railroads to change. Governor Hogg said in a speech in 1892: "The railways of this State according to their sworn reports filed last October with the Comptroller have outstanding against them \$155,250,744 in stocks and bonds; or an amount more than one-half the assessed valuation of all the property within the State, including the railway themselves." "These roads are rendered for taxation at a valuation of \$63,000,000." There is no doubt but that at the time Governor Hogg spoke, the roads of Texas were highly overcapitalized. In overcoming that evil, the Stock and Bond law and the consistent policy of the Commission have rendered an excellent service, but it seems that the evil of overcapitalization with but few exceptions has ceased to exist in Texas, and there seems to be some need for a change of policy that will foster the development and construction of Texas roads.

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RAILWAY CAPITALIZATION IN TEXAS AND THE VALUATIONS OF THE TEXAS COMMISSION.

W. D. WILLIAMS,
Of the State Railroad Commission.

So far as I can tell, all effort at change in political or social affairs is either temporary and soon abandoned, or it is toward a purpose which I may call moral.

So far as I can see them, the moral considerations affecting the fixing of rates for the services rendered by railroads as common carriers are quite simple. The public, acting through the government, has authorized investments to be made in a business without which society and civilization can not continue to exist in their present forms. This business is of such magnitude and importance as to affect the welfare of almost every citizen. It could take fortunes from those who had not its good will and give fortunes to another and favored few. It could build up industries where it wished and destroy other industries where it pleased. It had power over city and country alike, subjecting one place to another, and burdening one section in order that another might prosper. It was in self-defense that society undertook the regulation of railroads.

But, while it felt constrained to undertake the regulation of its own internal carriers, society has consistently tried to keep that regulation within certain definite moral bounds. The government has invited investments in railroads. Certain of these investments have been made. The government has undertaken the regulation of the railroads and this is practically a regulation of the investments which were made upon invitation. Narrowing the question for the time being to one of profits alone, what has the investor the moral right to demand, and what has the government the moral right to deny?

There is great difficulty in treating such matters upon purely theoretical lines. All true theories will work in practice; if it were otherwise, if a theory fails upon a practical application, then either the theory is not in accord with the truth, or an at-

tempt is being made to apply it to circumstances to which it has no logical relation. In rate matters, the great trouble is to develop a theory which is sufficiently broad to include all the details. If there were but one railroad in the United States, and it ran from Dallas to Amarillo, the problem of fixing rates would be presented in its simplest form. There would be no competition either by land or water. There would be no other transportation lines that would be affected. A Commission having jurisdiction of the subject could proceed to ascertain the value of the property; it could separate terminal from strictly transportation services, determining the cost of each; it could ascertain the overhead charges,* and arrive at a result which would be based upon conditions upon that one railroad alone. The cost to the carrier of the service rendered with a fair profit added would be the theory.* Both the cost and the profit would depend to some extent upon the value of the investment. Yet, even in this simplest form it is difficult, indeed it is impossible for me to perceive by what moral right, the owners of this railroad would support their claim that the "good will" and the "established business" of the railroad should be taken as part of its capital value for rate-making purposes. It would have a monopoly of all business that could possibly move between points on its line. Its good will would be absolute and without limit. Yet, for all this, it would be entitled to no more than reimbursement for its reasonable expenses, and a fair profit upon its business. This profit could not be allowed without regard to its investment, since to do so would be to disregard one of the main purposes which brought about the regulation of railroads. It would be to capitalize for individual and private benefit the necessities of all of the public that is tributary to the line. And it would defeat the rate-making power by denying to it any standard by which to measure its rates. More than all this, if the value of "good will" and "established business" were allowed as a capital value and stocks and bonds were issued for the same with the consent of the State then, when these values were taken away by the construction of competing lines, rates would still have to be

*In these statements the writer slips over into the subject of value of service, or rates. (Ed.)

maintained as at first fixed. A purely transitory element would have been used as if it had been eternal and a perpetual charge would have been put upon the public without a shadow of right.

Neither do I find any other circumstances under which the State may allow to a railroad the value of its good will and established business in such manner that these elements are made or may become in the future a basis for use in the fixing of rates. And here I develop an opinion which runs counter to that expressed by the author of the preceding paper.

But, first, let us change the location of our imaginary line of railroad. Let us suppose it now to run from New York through Chicago, Omaha and Denver, to San Francisco, it being still the only line in this country. In this case, there would be elements of competition by water between the two ocean terminals and between certain other points, but as to all non-competitive points, it would have a monopoly of the business. And, in addition, it might by the exertions of its traffic officials, or by reason of its superior service, or for any one or more of other good business considerations, establish such relations with shippers as would give it an advantage over its competitors by water, and bring to its rails traffic which it could not otherwise secure.

After it had done all this, its business would still consist of transportation of which it had a monopoly for the time being and of that other traffic which came to it because of friendly personal and established business relations. And in neither case could it rightly ask to have the value of these items added to its capital account for all time to come.

There is an assertion frequently made in these days that the amount of outstanding stocks and bonds of a railroad is of no consequence when it comes to the fixing of rates for transportation over its rails.* This is not even correct when the stocks and bonds have been issued by a company over which the State is exercising no control. The Nebraska rate case did not attempt to lay down any rule as to the weight to be given to such evidence, but it did establish it as a principle of law that, in considering the fairness of rates established by the State, the courts would look, among other things, to the stocks and bonds of a railroad. It follows of necessity that that which is evidence in a court

**See above, pp. 85, 95. (Ed.)

should be considered also when the government is exercising its rate-making powers.

In the Nebraska case, the stocks and bonds had not been issued under any express and specific authority. The railroad had acted under its general statutory power and the issues had not been restricted or controlled by the State. In cases where stocks and bonds are limited by law to amounts which are ascertained and fixed by a public board or commission or by legislative enactment in each particular instance, there can be no doubt, I think, that the government will be obliged afterward and as long as these stocks and bonds are outstanding, to regard the aggregate amount thereof as being a sum below which it may not go in determining the value of the property for rate-making purposes.

I have already instanced two imaginary lines of railroad, extending across portions of the country, under circumstances which are in certain respects dissimilar, and have used the illustrations afforded by these to show, as well as I could, the inadvisability and actual impropriety of allowing good will and established business values for capitalization and rate-making purposes, and incidentally I have tried to make it plain that a regulated and governmentally authorized capitalization is itself a fundamental part of the rate-making process and must for this reason be governed by the same principles. In its actual operations, however, the State deals with no cases so simple and obvious as is the more complicated of the hypothetical situations upon which I have somewhat briefly dwelt. The lines from New York to San Francisco are paralleled in every part of the distance. They are crossed backward and forward in every direction. They form part of a vast and intricate system in comparison with which a Cretan labyrinth would be as easy to follow as a daylight road, between continuous lines of fences, across a prairie country. Competition comes from every direction and extends in every direction. And yet, notwithstanding this, there remain some stations which are not competitive, there is some part of the business of the road of which it still has a monopoly, and there is now but little probability of a serious diminution of this part of the traffic. Shall we then consider this as a permanent element of value, and allow it to be capitalized, and use it

in fixing rates? Certain localities suffer disabilities, in transportation by reason of their lack of competition, and it is proposed to capitalize these disabilities, give a plus value to the same, donate this value to the owners of the line which monopolizes the transportation, and spread the burden over all the commerce of the country.* To state the proposition is to demonstrate its unsoundness. Governmental regulation of railroads was instituted to prevent just this sort of thing.

Good will is "the value that a business has over and above the stock in trade and money invested in it." It is "the established popularity of a business tending to maintain its custom." Now in equity, it is not the excess of value above investment, or the popularity of an agent or management or business but only the invested stock in trade and money which conscience requires that we shall protect while we are regulating railroads. It is upon this that the company must have interest and profits. This it is and this is all of it that the owners have parted with upon the public invitation when the way was left open for private capital to go into the railroad business. This and no more than this is what the owners would have had, if they had kept out of the business. I have no hesitation in saying that, if ever we come to where we shall under governmental regulation permit the permanent capitalization of monopolized traffic, or of railroad "good will," or "established business," then it would have been better by far had we kept out of governmental regulation entirely.

A railroad system whose main line runs from Chicago to Denver, with branches extending in all directions, comes under the control of an active and skillful executive, who selects for himself the best of assistants and puts his force at work extending the business of his company. He succeeds and after years of effort, the traffic of the system is double that of its nearest competitor. This is the result of "good will," it is "established busi-

*The editor can not refrain from calling attention to the fact that railways rarely compete as to rates, and can not do so normally. It is not desirable that they should do so. This is a well-established economic doctrine. This fact need not vitiate the writer's conclusion, however, for the real basis of his argument lies in the fallacy of leaving rates to be determined by earning capacity. The "disabilities" referred to arise out of exorbitant rates due to lack of a proper basis of regulation. (Ed.)

ness." No sooner has this great task been accomplished than the owners mark up the prices of their shares of stock. A great railroad and a great railroad man are always shining marks for all gatherers of news. Every avenue of publicity is open to them, and they advertise their success until the four quarters of the world are ringing with it. The public buys the stocks of this system, and of course the public could not buy if the owners did not sell. The owners are taking one harvest of their crop of "good will" and "established business." But a single harvest is not enough. It never is enough. If there is no governmental regulation, the owners issue some more shares of stock or more bonds, and by this simple process they for the second time proceed to capitalize their success.

Now, "good will" and "established business" are things which are transitory in their very essence,* and no one knows this better than the railroad owner. The time comes when another company takes over the men who built up this first system, or ill health impairs the vigor of the controlling power, or death takes him away, or another and younger man of equal capacity is put in charge of a competitor, or any one of a multitude of other causes destroys part or all of this "good will" and "established business," and gives it to some rival. And this rival capitalizes it once more, and reaps two harvests from the single crop, and it passes on to another railroad, and the public is given another good investment for its money, or perhaps it would be better to say another investment for its good money. The game is fascinating, but it is not to the interest of society that it shall continue to be played, at least, not in public places.

This does not mean that the increased business brought to a railroad by good management, courtesy and efficient service shall be taken away from it and destroyed by railroad regulation. Good management and efficient service and courtesy to patrons are paid for as a part of the operating expenses, and whatever is gained by them, while it is not a gain to the railroad business of the country as a whole, but is something which is taken from one or more other lines and diverted to the more successful carrier, is in right and justice the property of the successful line

*Cf. this and the following paragraph with the reasoning found above, pp. 89, 101f.

so long as such line can hold it in competition with its rivals. But it is not permanent property and must not be capitalized as a perpetual charge against the public. If this capitalization were allowed to the successful road, it would follow that the capitalization of its competitors should be diminished by an equal amount, and in my judgment all this is entirely apart from the purpose of the State in assuming the regulatory function. At the same time the State will not interfere as between the competitors and will not attempt to take away from the one that which it has gained at the expense of the others, but will leave them within certain limits to fight among themselves as independent organizations, if they are such in fact.

The attempt which is now being made throughout the State to secure a revaluation of the old system properties in order to enable them to refund outstanding bonds with the approval of the State is, as it seems to me, in direct contravention of every principle which was in the minds of the citizens of Texas when they adopted the policy of railroad regulation. Governor Hogg in all of his campaigns in Texas charged these systems continuously with having watered their stocks and their bonds and demanded the enactment of statutes which would eventually squeeze the water out of these issues. The author of the preceding paper is mistaken in believing that this purpose has already been accomplished. The Railroad Commission has discharged its functions admirably, and one result is that there is no water in the stocks and bonds which have been issued since the Commission assumed control. This has had the effect of reducing the average of the stocks and bonds per mile of road from \$41,492.00 in 1895 to \$32,819.00 in 1911. This difference has been accomplished without the retirement of any of the stocks and bonds which Governor Hogg charged had been excessively issued. In only one instance, which is that of the International & Great Northern Railway Company, has any such reduction been accomplished, and if it is right that revaluations should be made which will permit the other systems to reissue all the old stocks and bonds then unquestionably a wrong has been done to the International & Great Northern Railroad Company, which is entitled to the same treatment under the law that is accorded to all others of our inland carriers.

Let me call to your attention for a moment how the law operates in its practical workings, and I believe you will see that nothing more is required under its provisions than a good system of bookkeeping and fair reports to the Railroad Commission to keep the valuations at the point at which they justly and rightly should stand. The valuations of the main systems in Texas took place in the early nineties in the last century some eighteen years ago, and I can not pretend to any personal knowledge as to the correctness of the same. The law provided then, as it provides now, that a railroad company dissatisfied with a valuation made by the Commission might file its protest and might by proper proceedings, in no wise difficult to follow, secure a review of the valuation in the courts of the country. The railroads made no protest under the statute against these original valuations and took none of them into the courts; and they stand, under the law, as final and conclusive and practically as having been consented to at the time by the interested lines. Subsequently nothing more has been necessary for a railroad to do to keep up its valuation save to return an annual account to the Railroad Commission showing what moneys it had expended during the year for purposes properly chargeable to Capital Improvements. I have already said that in my judgment the law was intended to protect, as far as it could be done, the reasonable investments made in railroad properties in Texas and that nothing more than this is required in equity as between the public and the carriers. The original valuation was an effort to get as nearly as could be at the amount reasonably invested in the roads then in existence and the fact that roads could then be built for much less money than now was rationally taken into consideration at that time and could not in fairness be omitted. Having arrived as closely as possible at the investment value of the roads in those days and having received annual statements since showing every purported expenditure for "Capital Account," the records of the Railroad Commission today enable that Commission to determine the investment value of each road in the State just as far as that road has been willing to report its investment expenditures to the Commission. Surely the roads ought not to be heard to complain that they did not from time to time realize the effect of their actions and made reports of

betterments and additions which were not correct and which did not truly set forth all that they had expended for such purposes. To give a revaluation for such a reason as this is to invite and knowingly to reward unfair methods in withholding facts from the public.

Neither do I believe that railroads are entitled to a revaluation every time their physical properties increase in value. If this method is followed, no valuation is of any consequence and no valuation should ever be attempted. The State must upon that theory increase the value and increase the amount of stocks and bonds authorized to be issued in times of prosperity when prices are high, but there is no method provided by which they can diminish these values or compel the calling in of stocks and bonds in periods of great distress when values diminish. Such a course if pursued long enough would bring every railroad property in the country to the very top notch of boom values, and as a protection to investors it would be a mockery, while its effect upon the public would be in the highest degree injurious.

In my judgment, the railroads of Texas are now reporting to the Railroad Commission with all the accuracy that can be demanded the amounts expended from year to year in operating expenses and the amounts expended in betterments and permanent improvements so that as to reports which are made within my experience I think it quite probable that they show the true investment situation as affected by the operations for the last few years. This policy if pursued in the future will inevitably bring about a better situation and will enable the Commission to deal with the situation with full knowledge as to its details.

There is one change in the law which I believe should be made, and this change is one which will authorize the issuance of bonds for capital improvements regardless of the existing indebtedness of the company, giving the Commission power, if the Legislature sees fit, to look after the expending of the moneys realized from the sale of the bonds and providing adequate penalties for any misappropriation of funds which are so derived. But I am unable to see my way clear toward supporting the other amendments which are now being advocated.

I am greatly gratified, no matter how I have myself on account of limited time fallen short in the presentation of this subject.

to know that it receives the attention of the faculty and students of the University of Texas. In my judgment, the most important subjects for public consideration in this country at least for many years to come will be inland transportation, taxation and conservation of the soil, and we must look to our educational institutions to train new generations of citizens to study and think upon these subjects. The University of Texas is doing its part in this work.

IV.

Taxation

THE EVILS OF THE TEXAS SYSTEM AND THE REMEDIES

SOME TAX NEEDS OF TEXAS.

E. T. MILLER.

The most important question to be asked concerning any system of taxation is: Does it operate so that each person is taxed approximately according to ability to pay? In applying this question to the system in Texas, taxes levied for sumptuary or regulative reasons, such as liquor taxes, and exemptions made on political or social grounds, may at once be excluded, for in these cases other considerations than revenue prevail.

Inequality in Assessment.

The general property tax is by far the most important of all the taxes levied in this State. According to the federal census of 1902, it made up 64.8 per cent of the general revenue receipts of the State, counties, cities, and other minor civil divisions. A question in which the people of this State should be keenly interested is whether or not the operation of this tax is such that those subject to it pay in accordance with their ability to pay. The candid answer by any one who knows anything about it is that it is not. The base of this tax is all real and personal property, and the State rate is a uniform one upon all classes of such property. Real property being immovable and visible is more completely assessed than personalty, particularly intangible personalty,—such as money, credits, and securities. The less valuable holdings of real property, furthermore, are more fully assessed than the more valuable holdings, and this holds true also of large holdings of personalty, such as are to be found in department stores and in mansions as compared with the smaller holdings in less pretentious establishments and homes. Some property thus escapes assessment, and in the case of that reached there is further inequality between individuals, between town and country, and between counties, because of the varying percentages of assessed to true value which are employed. In the assessment of the State tax on property, the standard of assess-

ment—whether full value or a per cent of full value—is unimportant as compared with how the selected standard operates. Where undervaluation has long been practiced, the relation of municipal indebtedness, assessors' fees, and special taxes to assessed values may present considerations against a sudden change to a full standard. Full rendition, however, should be required, but whether or not the full rendered value or a per cent of it shall be the base should be decided in the light of the conditions existing in the State with respect to the above and other considerations. Texas laws call for full rendition and the employment of the full standard, but though the "full rendition law" resulted in substantial additions to the tax rolls, it has not succeeded in its object. Except for the unwise policy of encumbering the statute books with unobserved laws, the fact that there is not full rendition is not the important one. But the fact that is important and that should be more real concern to the people of the State than it appears to be is that there is absolutely no uniformity in the amount of undervaluation practised. This results in gross injustice among citizens of the various counties in their contributions for the support of the State government. The lack of uniformity is shown by a comparison of the average true value of agricultural land in each county as given by the Thirteenth Census with the average value as given in the report of the Comptroller for 1911. The census excludes some lands which if included would diminish its averages, but this is more than offset by the inclusion of the value of farm buildings in the assessors' averages. The comparison shows that in six counties the per cent of assessed to true value was under 20; in thirty counties it was between 20 and 30; in thirty-nine, between 30 and 40; in sixty-four, between 40 and 50; in forty-three, between 50 and 60; in twenty-seven, between 60 and 70; in thirteen, between 70 and 80; in seven, between 80 and 90; and in only six was it 90 and over. Five of the six counties which are assessed at 90 per cent and over are east Texas counties which have comparatively small population and wealth. The wealthiest counties fall as a rule below 50 per cent, though they show variations among themselves. It is not necessary to make any individual comparisons and single out notorious shirkers, for the point to be established is that there are numerous and

wide differences among the counties. So long as there is a general property tax imposed for State purposes and there is no State machinery for equalizing it, this situation of inequality will persist.

Remedies: Separation of State and Local Taxation.

Separation of the sources of State and local revenues has been proposed as a remedy. Separation, by abolishing the State property tax, obviously would do away with the inequality of its operation among the counties. It is very doubtful, however, in view of State support of public education, whether complete separation is adapted to this State; but this and other considerations need to be investigated before one is in a position to form an opinion. The plan has been adopted recently in California, but so recently that no conclusions can be drawn at this time as to its efficiency. Other States approach separation more nearly than does Texas, though none have gone so far as has California. On the other hand, Connecticut in 1909 and New York in 1911 found it necessary to return to the employment of the State property tax, after some years' experience with separation.

An alternative remedy to separation is the apportionment of the amount to be raised for State purposes among the counties on the basis of their expenditures. This novel plan has been adopted by Oregon, but besides being too new to afford any conclusions as to its operations, it does not appear to suggest a sufficient observance of the ability to pay principle in the taxation of individuals for State purposes.

Centralized Administration: State Tax Commission.

The plan to which most of the States which have faced the problem of inequality among counties have turned is a strong State Tax Commission. The most successful of these commissions are composed of from three to five members who give their entire time to the work. They are appointed by the governors for varying terms, usually from four to six years, are sufficiently well paid to attract men of ability, and are invested among other powers with that of equalizing values. In the States where

such central supervisory boards exist, and notably in Wisconsin, Michigan, Kansas, and Minnesota, the defect of inequality among counties in the assessment of real property has been largely corrected. These States have realized also that as the foundation work of good assessments rests with the local assessors, it is especially necessary to ensure as far as possible that this work should be well done. Such States, therefore, require that the members of the commission shall visit the assessors, advise with them, and instruct them as to their duties. Reassessments may be ordered by the commission, and the power of initiating proceedings looking to the removal of incompetent assessors is lodged in its hands. At the Richmond, Va., meeting of the National Tax Association, in September, 1911, a vote was taken of the delegates on the need of a central supervisory system, and it was unanimous in favor.

It is the practice in States having tax commissions, tax commissioners, and State boards of equalization to entrust them with the assessment of the real and personal property of railways and other public-service corporations. The average local assessor and county board of equalization is not in a position to assess properly property of this complicated character, but a State board may possess or command the expert knowledge required. In this State there is no central administrative machinery for the equalization of values among the counties or for the assessment of corporate property, except the intangible values of railroad, ferry, bridge, and turnpike companies. And it appears that no such machinery may be provided without a change in the constitution. The constitution contemplates justice in taxation and enjoins equality, but it does not permit the creation of the machinery necessary to secure them. Instead of proposing a change of this document, new oaths and penalties have been clapped on assessing and other officials, the sure failure of which a little acquaintance with the experience of other States would have foretold. Experience with the full rendition law demonstrates conclusively that our constitutional and statutory provisions for securing equality in taxation are primitive.

The powers of the Texas State Tax Board extend to the investigation of the operation of the tax laws of the State and to visitation of the counties when directed by the governor, but

these powers fall far short of what are necessary. The composition of the board, moreover, is not adequate to the task, for two of its three members are State officials whose other duties are too numerous to permit them to perform more than merely formal acts in their capacity of ex-officio members of the tax board. The work of the board so far has been merely that of ascertaining the values required by the Intangible Assets Law; exercise of its other useful powers has not been possible because of the limitations imposed by its composition and because the legislature has failed to appropriate sufficient funds.

The Problem of Taxing Intangible Property and Credits.

Separation of the sources of State and local revenues, apportionment of the State tax on the basis of county expenditures, and State tax commissions, serve to do away with the unequal operation among the counties of the State tax on real property. They, however, are able to do little or nothing towards remedying the inequality between tangible and intangible property, which is another and more unyielding defect of the general property tax. The stringent laws which have been enacted at one time or another by all the States of the Union to reach intangible personalty directly have failed. Taxation of such property at a rate which appropriates a large share of the income has uniformly resulted in evasion of the taxes or in the flight of the property to more hospitable regions. There are valid grounds for considering the taxation of both the credits and securities and the property which they represent as double taxation. It is recognized in this State to the extent that the shares of stock of domestic corporations, whose property is subject to taxation in the State, are exempt. There is also no double taxation of the values represented by bank stock. The law, however, does not carry out this principle of exemption to its logical conclusion, for there is no very valid reason for treating differently stocks on the one hand, and bonds and credits, such as vendors' lien notes secured by mortgages, on the other. All alike represent an interest in property, and to tax both the credit and the property is double taxation. Now all double taxation is not iniquitous, but, on the contrary, there is some which secures taxation accord-

ing to ability. That practised in this State, however, may not be so justified. The Texas law permits one to deduct interest-bearing debts from interest-bearing credits. This is not only a favorite loophole for the intangible property owner, but is also a discrimination in favor of the creditor class. That the creditor, say the mortgagee, shifts through a higher interest rate or more devious methods the tax on mortgages to the debtor, or mortgagor, is an economic principle which is little questioned. As the taxes which are shifted to the creditor are offset by the taxes which he shifts to others, and as the taxes on the excess of his credits over his debits are also shifted through a higher interest rate, the result under the Texas law is that the creditor escapes taxation on his credits. The debtor, however, who has no offsetting credits, has no relief. He is taxed on his mortgaged property and pays also through a higher interest rate the tax on the mortgage. Undervaluation of mortgaged property and the escape of assessment by credits may somewhat mitigate the effects of these principles, but the debtor class undoubtedly bears the heavier burden.

Some States exempt mortgages from taxation; some regard them as an interest in the property and permit the mortgagor to deduct the amount from the value of the property; some subject them to a light recording tax or to a low rate of taxation, while others follow the method used in Texas. The method of taxing not only mortgages but intangible personalty generally that would be most appropriate to this State needs to be investigated. The present method operates unequally, but whether the policy should be exemption or a lower rate on intangible than on tangible property or an income tax can not be answered until all the conditions have been examined. In Wisconsin there goes into effect this year an income tax as a substitute for the tax on personal property. New York and Minnesota have the recording tax on mortgages. Maryland, Pennsylvania, Minnesota, and Iowa permit the classification of property for purposes of taxation and tax intangible property at a lower rate than tangible. Reform along any practicable line is probably not possible in this State, however, without a change in the constitutional provision requiring uniform taxation.

Corporation Taxation.

The general plan of the existing system of corporation taxation in this State conforms in the main to that approved by the best practice in the country. It is a question, however, whether the gross earnings method of taxing railways may not be better than the ad valorem. The two chief advantages claimed for the gross earnings method are that the base more nearly represents ability than does property and that it is superior in simplicity because it avoids the difficult process of valuing the complicated property of the corporation. Though there may be a division of opinion as to the relative merits of the ad valorem and the gross earnings methods, there is no question about the superiority of centralized assessment of the ad valorem tax over assessment by multitudinous assessors. Only in the matter of the determination of the intangible values of railways has the Texas system departed from what is called the "primitive method" of administering the property taxes on railways and similar public-service corporations. Even with our uncentralized method of taxing such corporations, it is probable, in view of the escape of the personality and the underassessment of the reality of individuals, that such corporations are more nearly taxed according to ability than are individuals.

A Special Tax Commission Needed.

The hurly-burly of a legislative assembly does not afford the appropriate conditions for a searching and conclusive investigation of the ills of a system of taxation and for the discovery of the remedies. Such work to be freest from prejudice should be authorized by the State, and to be thoroughly done its conduct should not be wholly in the hands of members of the legislature or of State officials. The time and undistracted attention of a body of men chosen to represent all the various interests of the State are called for in such work. These men should be constituted a Special Tax Commission, whose duty it should be made to investigate the State's tax system from top to bottom and to report to the legislature their findings and suggestions in the form of laws. The commission should be fully empowered

to compel testimony, examine books, and employ expert assistance; it should be directed also to study the experience and the systems of other States; and last, but not least in importance, it should be provided with adequate funds for the performance of the task enjoined. It would thus be able to do the preliminary work looking to a reconstruction of the system which the legislature is ill-adapted to do. During the last seven years some fifteen States have created such commissions. These states are California, Delaware, Illinois, Iowa, Kentucky, Louisiana, Massachusetts, Michigan, Missouri, New Hampshire, New York, Ohio, Rhode Island, Virginia, and Vermont. —States representing every section of the country. The members numbered from three to fifteen, but fifteen were found to constitute too unwidely a body. California appropriated \$45,000 for her commission, Illinois \$25,000, Kentucky, Massachusetts and Missouri each about \$15,000, and Virginia and Iowa, \$10,000. It may be safely said that conditions in these States called no more urgently for investigation than they call in Texas at the present time.

THE EVILS OF THE GENERAL PROPERTY TAX IN TEXAS AND THE REMEDY.

S. I. REINHARDT.

Of the States in the Union which still retain the general property tax and which, it may be said, are somewhat backward in methods of taxation, Texas is one of the most important. She still employs the general property tax, locally administered, as her main source of revenue.

The general property tax did very well when it was more suitable to the condition of the country. Before the Civil War, all property was more or less of a tangible nature, and could be easily reached, but now when property has taken on so many forms, this tax is hardly sufficient. Great corporations have come into being; stocks, bonds, and franchises have appeared since that time,—all of which are against the successful working of the general property tax. The increase in tax rates has intensified inequalities and aroused dissatisfaction. As indicative of the dissatisfaction with the tax, from 1867 to the present time, probably fifty special tax commissions have been appointed, and they have all practically agreed that the evils of the tax are ineradicable.

In Texas it was estimated in 1902 that property was assessed at about 54% of its real value. In the same year in January, money on deposit as given by the assessments amounted to \$11,500,000, while deposits in April, 1902, in National banks alone amounted to \$64,700,000. There is not only a great undervaluation, but there is still a greater injustice as between personality and real property.

The general property tax works unequally and unjustly between citizens of the same town. One may have his property assessed at 70% of its real value, while another may have his assessed at only 50%. It also works unjustly and unequally between the towns whose property is used as a basis for county taxes and between the counties whose property is used as the basis of the State tax. Property in one town may be assessed

as a very high value as compared with that in some other town in the county, in which case one town will pay more than its due share of the taxes to the county. The same illustration applies to the counties whose property is used as a basis for a State tax. When the property of the people is not assessed equally in the same town, when there is inequality between real estate and personalty, and when property is assessed unequally as between different towns and different counties, the constitutional requirement of uniform and equal taxation is a mockery.

Many remedies for the defects with operation of the tax have been suggested. Some have advocated the abolition of a tax on personalty altogether, but this does not accord with current notions of justice. Some advocate more stringent laws. This was tried in Texas in 1907 when the full rendition law was passed, and while it helped in a way, it failed to remedy the evils. Not only Texas, but practically every State in the Union has tried more stringent laws, and have found such a course to be no remedy. The classified tax has been advocated and tried in Maryland, Pennsylvania, Iowa, and Minnesota. This is a tax having different rates for different kinds of property, the least rate being on intangible personalty. While it is a fact that this method will not reach those people who are determined to escape the tax, it results in more personalty being taxed than under the uniform method.

Another method, also, which has been used with some success, is the separation of State and local taxation. This plan is advocated for the purpose of remedying the evils of inequality between counties. But whether it would remedy the inequality between individuals in the same community and between personal and real property is a question. It has been suggested that the State be allowed to tax corporations and inheritances,—the cause for the first being that the corporate business is more or less an inter-county business. The plan is in a way an attempt to identify the economic jurisdiction with the political jurisdiction.

The reform, which comes nearest to being a real remedy for the evils of the general property tax, is the centralized system of administration. Indiana, Wisconsin, Michigan, New York, Minnesota, Kansas, West Virginia, and several other States have

such a system, and it has proved to be a success. In Minnesota, for example, the Tax Commission was created in 1907 consisting of three members appointed by the governor with the approval of the senate, not more than two of whom may belong to one political party. They supervise all boards of equalization and assessments in the State. They meet the county officers every two years. They have the power of compelling the owners of property and others to give information, and they have the power to equalize between individuals and between counties.

In Wisconsin the system is practically the same. The commission watches transfers of property and keeps up with the business transactions. Corporate property, railroads, telegraph and telephone lines are assessed by the commission. With some variations, the powers of the commissions of the other States are the same as those of Minnesota and Wisconsin.

In the Texas system, the assessors are responsible not to a State tax commission but to the people, and their re-election depends not so much upon the enforcement of the law as upon laxity in its observance. If an assessor is liberal he has a good chance of reelection, but otherwise his chances are not so good.

Centralized administration has been used by the most progressive States in the Union, and there is no reason why it should not work with success in Texas in correcting the inequalities between the counties in the matter of tangible property assessments. The classified property tax appears to be the most practicable, and at the same time just, method of correcting the inequalities between real and personal property.

THE PROBLEM OF SECURING JUST MUNICIPAL TAXATION IN TEXAS.

A. P. WOOLDRIDGE,

Mayor of the City of Austin, Texas.

The provisions of the constitution of Texas regulating taxation are antiquated, and until these provisions are amended or abolished, taxation in Texas can be neither just nor efficient. The constitution of Texas, in Article 8, Section 1, contains these words, "Taxation shall be equal and uniform. All property in this State whether owned by natural persons or corporations other than municipal, shall be taxed in proportion to its value, which shall be ascertained as may be provided by law." These sentences to a casual reading seem harmless enough, indeed they read as though they were an epitome of right, wisdom and justice, and doubtless these provisions in our organic law were fairly good and fairly efficient, and fairly well adapted to our economic conditions when enacted some seventy-five years ago, but they are not suited to present conditions.

The vice of these words consists in their rigidity, and now when our economic conditions have so greatly changed from those of our ancestors, the inelasticity of our constitution in matters of taxation has been productive of the greatest injustice, inequality, inefficiency, and wrong.

The laws of Texas, and the ordinances of the cities of Texas made in conformity with the above provisions of our constitution, seek to tax all sorts of property, real and personal, tangible and intangible alike, in the same proportions and by the same methods. This is impossible, and an increasingly large part of the wealth of our people, especially of the people who live in the larger cities of Texas and where wealth is largely in the intangible form, almost entirely escapes taxation. As an illustration of the small part that money and credits contribute to taxation, I will here cite the amount of money and credits rendered for taxation in Austin in 1911, and show how small a proportion

they are of our total assessed wealth and how small a proportion the money assessed is of our known deposits.

In 1911 our assessed values, which were about 66.6% of true values as to real estate, and were an unknown per cent of true values as to personal property, amounted to \$20,157,756. Our assessed credits, meaning thereby principally notes owned and held by taxpayers, amounted to \$688,391, or less than 3.5% of our total assessed values. The true amount of loans held in this community is not known. It can not possibly be ascertained. The true amount is believed by the city assessor and collector very greatly to exceed the amount rendered. The amount of money rendered for taxation in this city in the year 1911 amounted to \$131,457, or only 0.65 per cent of our assessed values.

The total deposits of the Austin banks on April 18, 1912, were \$7,351,622.84. The amount of individual deposits, including certificates of deposits, in all of the banks of Austin, Texas, on the 18th day of April of this year amounted to \$5,182,140.77. There were also deposits owing to other banks and bankers amounting to \$1,498,907.63, but I do not include these deposits in the deposits out of which I am trying to deduce conclusions in this argument. Nor am I including government deposits, amounting to \$237,285.09. Nor am I including certified checks and cashiers' checks, which are a form of deposit, amounting to \$430,301.13. I am excepting from this statement deposits amounting to \$2,166,493.85. I am reasoning only from the amount of *individual deposits* held by the Austin banks on April, 18, 1912, and presumably owing by the local banks principally to people living here and hereabouts. These individual deposits amounted to \$5,182,140.77.

Out of these deposits but \$131,457 or 2.5% was rendered for taxation, and the balance, \$5,050,683.77, or 97.5%, was not rendered for taxation.

I do not cite the instances of low assessments of money and credits so much to condemn that practice as to show the absolute futility of trying to reach these forms of property for taxation. Indeed, for many reasons, especially the moral debauchery it brings to our people, I believe money and mortgages should be either exempted from taxation or taxed by a wiser and juster

method than is now prescribed by our General Property Tax Law.

We may then assume the need of reforming our General Property Tax Law, either by the substitution of a classified property tax law, or as an amelioratory temporary step—if such should be found permissible under our constitution—a recording and registering law, or something else as good or better. I think the next best thing for just and efficient municipal taxation after a reform of the general property tax law, is the separation of sources of municipal revenue in part at least from those of the State. Perhaps this procedure is more immediately practicable, and should even precede the reform of the general property tax law.

It seems to me that the State should not look to *ad valorem* taxation for revenue. The State must either abandon *ad valorem* taxation for its support, or appoint a central board of equalization, for under the present system of *ad valorem* contributions to State revenue, the grossest sort of inequalities of rendition will continue to be practiced by the various counties of the State. This source of revenue seems best reserved for localities; as are also in part, at least, certain license fees and occupation taxes, and perhaps even a gross-receipts tax against *local* public-utility corporations.

As to the municipal assessment of local real estate, I would assess land at as nearly its full cash market value as possible. I would then assess improvements upon lands just as tenderly as our unfortunate general property tax law would allow. In fact, I would stretch several points to assess improvements upon land as generously as reason and a liberal conscience would permit. The value of land is chiefly a social product. The thrift and enterprise of the owner often have not contributed much to its enhancement in values; and, moreover, the bulk of municipal taxes go back to the owners of land in its special improvement. Land tends to appreciate in value in growing communities. The reverse of this is true as to improvements upon land. Improvements tend to deteriorate in value, and here the thrift and enterprise of the owners count for a great deal, and this thrift and enterprise should be generously rewarded in low valuations.

But it is vain to talk much about reforms in municipal taxation so long as real progress is blocked by our inelastic constitutional provisions. It seems doubtful, if not certainly otherwise, that we can treat any one form of property differently from another. I will therefore conclude with a recommendation made by the National Tax Association in 1907. That association advised the adoption of the following phraseology to be placed in the constitutions of States which desire to obtain this necessary legislative freedom:

“The power of taxation shall never be surrendered, suspended or contracted away. All taxes shall be uniform *upon the same class of property* within the territorial limits of the authority levying the tax and shall be levied and collected for public purposes only.”

THE TAXATION OF CORPORATIONS IN TEXAS.

L. G. DENMAN, JR.

Formerly, it was taken for granted that a general tax on the real and personal property of a community would most equitably distribute the burden of taxation. But with the growth of modern business methods and organizations, it has gradually become apparent that the general property tax fails to reach a large proportion of the property of the State. Experiments have been made along many lines. Taxes on corporate excess, gross receipts, net income, franchise taxes, and various other systems have been experimented with by State governments. Other experiments have been made along the lines of practical assessments and expedient collection of the tax. In many ways, Texas has endeavored to keep abreast of these developments, and provide her people with the most equitable and, at the same time, the most practical system of corporation taxation.

The general property tax is applied in a peculiar manner to some corporations and businesses considered to be of a special character. In the case of railway corporations, real and personal property is rendered to the local assessors, with the exception of the rolling-stock. The rolling-stock is rendered in the county where the principal office is located. The county assessor reports it to the Comptroller, and it is then apportioned among the counties according to the mileage of the railway each contains. A more distinctive feature is the assessing of the tax on intangible assets, which applies to railway, ferry, bridge, and turn-pike companies, as well as to individuals and associations pursuing such businesses. "Intangible assets" represent the difference between the total true value of the property and the value of the tangible property. A State tax board, composed of the Comptroller, the Secretary of State, and the Tax Commissioner, determines the amount of intangible assets, with the assistance of reports from the taxable persons. It then notifies the county assessors of the results, and these are taken to be a proper base for taxation by all who use the general property tax.

Another general property tax of special nature is that levied on the domestic life insurance companies. They are taxed on their real and personal property less their reserve.

Incorporated State and national banks are taxed on their real property. Their shares of stock are reached in the hands of the stockholders. There they are taxed on their face value less the amount of real property taxed. Private banks are taxed on their real and personal property less money on deposit.

There are various kinds of taxes which apply peculiarly to businesses. Of course, the general property tax applies in its regular form to all businesses except those mentioned above, where there is a special form of the tax.

The important corporation occupation tax is the tax on gross receipts. It is levied on those pursuing the following businesses: express, telegraph, gas, electric light, electric power, water, street railway, interurbans, pipe lines, sleeping, palace, and dining cars, oil, wholesale liquor dealing, telephone, terminal railways, insurance, and others. These are businesses in which ability to pay is not fairly represented by the amount of real and personal property assessable. There is one prohibitive tax of fifty per cent on the gross receipts of pistol dealers. The rates usually run from one and one-half per cent to three per cent.

The gross receipts tax was extended to life insurance companies in 1909. Their gross receipts from Texas policies are taxed at three per cent, with various reductions to two per cent, according to the amount of their total reserve invested in Texas securities or Texas real estate mortgages. All other insurance companies are taxed at a two and six-tenths per cent rate on their gross receipts with similar reductions. These taxes are paid to the Treasurer, and are for State use only. In 1908 they brought in \$720,779, or 8.9 per cent of the total State revenue.

The next important corporation tax is the tax of twenty-five cents on the one hundred dollars of capital stock employed in this State by sleeping, palace, and dining car companies. There are various sorts of deductions from the amount of capital stock, cutting it down to comparative insignificance. This tax is payable to the Comptroller.

There is a franchise tax based on the authorized capital stock of corporations; unless it be exceeded by the undivided

profits, plus the surplus, plus the issued capital stock,— in which case the sum of the latter three items is the base. The rates differ according to whether the corporation be domestic or foreign. The tax is for State use only. In 1908 this tax yielded \$397,473 or 4.9 per cent of the total State revenue.

From this brief description of the present system of taxation in Texas, it is apparent that the State has not ignored the changes in modern business development, and has accepted many suggestions from recent experiments in taxation. But there are still many weaknesses in the system as it now stands, some apparant, and some open to debate. The fact that a constitutional amendment is necessary to make an alteration, and the deep-rooted opposition of the people to the uncertainty of a change, probably have been the chief obstructions to reform.

The most manifest shortcoming is in the method of administration. The local assessment and collection of State revenue has led to grievous inconsistencies and persistent attempts to shift the burden of taxation. The most important effort to remedy this condition was the passage of the Full Rendition Law. But the law is not enforced, and does not seem likely to be enforced under the present system. The Tax Commissioner's report of 1908, in referring to the difficulties of local assessment, says: "So far as state taxation is concerned, the unequal assessment of property in the various counties of the state has caused in the past and will continue to cause friction and dissatisfaction between the taxpayers of the different sections of Texas."

The expense of administration is needlessly heavy in proportion to the accuracy of valuation. In a letter of July 12, 1906, Governor Colquitt says: "Under the present system, there are as many valuations of the same railroad property as there are counties through which such railroads run." He suggests that the valuation of railroads and other such corporate property as a whole, according to a single unit of value, would save approximately half a million dollars per annum in the cost of administration.

The most effective and sweeping remedies for these evils seem to be assessment and collection of the State tax by a State board, and assessment and collection of the local tax by local boards under the supervision of the State board. These two boards

should work in harmony, the one accepting much of the work of the other in its valuations. The State board should be given power to hear appeals from the valuations made by the local boards. These appeals should be instituted either by the taxpayer or, in the form of inquiries, by the State board. It might be expedient for the State board to be a board of original assessors only for the assessment of corporations doing an interstate and inter-county business. For its other valuations, it might act largely as a board of equalization. These boards should endeavor to enforce the full rendition law by various methods, such as the comparison of rendered values with those testified to by experts. Such a system of administration as this should do much to overcome the evils of inconsistency and the lack of method which exists at present.

Texas has not been so backward in the selection of kinds of taxation, as in the administration of the taxes. Attempts have been made to meet the growing need for special provision for reaching the real tax paying ability of modern business organizations. Such measures as the taxation of intangible assets and the gross receipts tax are efforts to tax corporations in proportion to their ability to pay. During the last few years, there has been a great deal of discussion in favor of one or another of various methods of taxation of railways to attain this object. The one most generally recommended has been the gross earnings tax. Although the net earnings tax has the theoretical advantage of corresponding more accurately to the ability to pay, it has many practical disadvantages. The impracticability of determining the net earnings is alone enough to discredit this tax. On the other hand, the gross receipts tax, while not so nearly perfect in theory, makes up for this failing by its many practical advantages. It is true that it does not take into consideration variations in expense accounts. But it does, nevertheless, form a very good standard of ability. The tax is distinguished by certainty and ease of administration, and it appears to have been a practical success in California. "Gross earnings can be concealed or misrepresented only by outright and easily-detected fraud. Unlike property values or net earnings, they are not affected by differences of opinion, and depend on nobody's judgment or discretion. They are often a matter of published

record. After the gross earnings are determined, the rest is a matter of mere arithmetical computation." This means inexpensive administration. It contrasts very sharply with the expensive system of valuation of real and personal property and of intangible assests which is now a part of our tax administration. The gross earnings represent fairly well the norm of ability to pay. They are definite.

The many advantages of this system of taxation suggest very strongly a consideration of its extension to the taxation of railways in this State.

Besides the weaknesses which arise in the Texas system of taxation from the method of administration and those which arise from the method of basing the tax, there are numerous inconsistencies and much injustice arising from an improper fusion of the sources of State and local taxes.

Under the present system, for instance, a large corporation doing a State-wide business is taxed on all its intangible personal property in the county where its principal office is located. No consideration is given to the fact that the corporation draws its income from all over the State. The one county is allowed to participate more highly in the benefits simply because it contains the main office. Moreover, the special rights which such corporations enjoy under their charters are granted by the State and not by the county. Thus it is only proper that the taxes should accrue to the State rather than to the county. *The most efficient remedy for these defects in the general property tax as it applies to corporations is separation of the sources of State and local revenue. Local business and property should be subject to local taxation, and inter-county business and such taxes as the inheritance tax, should produce the State revenue.*

The separation of the sources of State and local revenue is recommended by the Texas Tax Commissioner in his report of 1908. In answer to one of the strongest objections to separation, namely, the danger of reckless State expenditures, he suggests that, "Economy of state management and a lively interest on the part of the taxpayer in state expenditures is insured by reserving to the state the right to levy a general property tax in case of a deficiency in the general revenue and, per-

haps, in other emergencies." However, it is debatable whether this mere threat would be efficient.

Besides the objection to separation on account of its tendency towards creating extravagance on the part of the State government, it is complained of as being inelastic. This objection may be partly met in Texas by the employment of the inheritance tax, the poll tax, and certain taxes, the control of which should be reserved to the State on account of the need of uniform regulation. These are such taxes as license taxes, particularly the liquor license tax. The proceeds of this tax might be shared between the State and sub-jurisdictions.

New York, New Jersey, Connecticut, Vermont, Pennsylvania, Oregon, Delaware, and Wisconsin defray their State expenses principally from a taxation on corporations and other taxes apart from the general separation. So this plan of taxation is not an untried one.

CONSTITUTION OF THE TEXAS APPLIED ECONOMICS CLUB.

ARTICLE I.

SECTION 1. The name of this society shall be THE TEXAS APPLIED ECONOMICS CLUB.

ARTICLE II.

SECTION 1. Its purpose shall be to apply the principles of the science of Economics to the solution of the industrial and financial problems of Texas. With this end in view, the Club believes that it is essential, first, to understand the principles of Economics; second, to understand the economic and industrial situation in the State, together with its past development; and, third, to learn from the experience of other States. In order to further its ends, the Club will endeavor to secure the co-operation of the officials and representatives of the State Government.

ARTICLE III.

SECTION 1. The aggregate membership of the Club shall embrace two classes of members as hereinafter set forth. (1) There shall be an Active Membership which shall convey a recognition of (a) excellent work in Economics or (b) of active and important service in applying economic principles. The active membership shall consist of students of Economics and shall be on a basis of sound scholarship; but may include non-student members as indicated under (b) above, providing such persons shall take active part in the investigations of the Club. Nominations for active membership shall be made in October by a committee composed of the faculty of Economics and one student member to be elected at the last regular meeting of each year. Student nominees for active membership shall be passed upon by a vote of the active membership of the Club, a three-fourth's majority being necessary for election; except that the

recommendation of the nominating committee shall be final in the case of graduate students. Non-student nominees of class (b) shall be elected by majority vote.

Credit may be given for work done by active student members of the Club at the discretion of the nominating committee.

(2) There shall be an Associate Membership, to consist of persons who, not being eligible for active membership, will increase the effectiveness of the Club through ability, interest, or position in the affairs of the State. Such members shall be admitted upon nomination by a nominating committee; except that former active members automatically become associate members upon ceasing to be active members.

ARTICLE IV.

SECTION 1. The organization of the Club shall be as follows:

(1) The officers of the aggregate membership, comprising the Active and Associate Memberships, shall consist of a president, a vice president, a secretary-treasurer, and an executive council of five, to be known as president, vice president, secretary-treasurer and executive council of the Texas Applied Economics Club, respectively. Their duties shall be those which usually pertain to similar offices. These officers shall be elected at the annual meeting of the said aggregate membership, excepting that the chairman and corresponding secretary of the Active Membership shall *ex-officio* be members of the executive council.

(2) The officers of the Active Membership shall consist of a chairman, treasurer, recording secretary, a corresponding secretary, and a program committee. It shall be the duty of the treasurer to collect, hold, and disburse upon due authorization the funds of the active membership. It shall be the duty of the recording secretary to keep a permanent record of the proceedings and discussions of the said membership. The corresponding secretary shall, in consultation with the chairman, conduct the correspondence with the associate members, affiliated bodies, and the press. The program committee shall consist of the faculty members and two additional student members, providing that the student members shall not exceed the faculty members

in number. This committee shall plan the work of the active membership of the Club, and serve as a standing reception and entertainment committee.

ARTICLE V.

SECTION 1. There shall be an annual meeting of the aggregate membership, the time and place of occurrence of which meeting shall be fixed by the Executive Council of the Texas Applied Economics Club.

SECTION 2. Not less than five associate members must be present in order to constitute an annual meeting for the purpose of electing officers of the aggregate membership.

BY-LAWS.

1. The regular dues payable by each member of the Texas Applied Economics Club shall be one dollar, and shall be payable to the Secretary-Treasurer on the first day of October of each year.

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